S&P Global Ratings

Credit Conditions North America Q2 2022:

Hazard Ahead: Risk Intersection

March 29, 2022

(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 23, 2022.)

Key Takeaways

- **Overall:** Borrowers in North America may soon see the run of remarkably favorable financing conditions come to an end as intersecting credit headwinds could result in pronounced downside effects. While the region is comparatively insulated to the effects of the Russia-Ukraine conflict, it is not immune to the fallout.
- **Risks:** On top of heightened geopolitical risks and worsening cost pressures and supply bottlenecks, we see a high risk that investors could soon demand significantly higher returns. This could result in the repricing of financial and real assets, higher debt-servicing costs, and tighter financing conditions.
- **Credit:** Credit markets have begun an about-face—kicked off by the aggressive tone of Fed policymakers and followed up by Russia's invasion of Ukraine. Nominal yields on U.S. corporate debt have risen quickly, returning to pre-pandemic levels in less than three months, which has kept many issuers on the sidelines.

With heightened geopolitical tensions adding to already-heavy price pressures and supply constraints, and the Federal Reserve beginning to battle nagging inflation with what promises to be an aggressive cycle of monetary tightening, borrowers in North America may soon see the run of remarkably favorable financing conditions come to an end.

While North America is comparatively insulated from the direct effects of the Russia-Ukraine conflict, the U.S. and Canadian economies—and the borrowers that operate in them—aren't immune to the fallout.

S&P Global Economics now believes that the effects related to the Russia-Ukraine crisis will shave 70 basis points (bps) from U.S. GDP growth this year, with the economy now set to expand 3.2%. The prospects of steadily rising interest rates and persistent inflation are the main drivers of this assessment, with an expected recession in Russia playing only a small part. All told, downside risks are growing, and we now see a moderate chance of recession in the next 12 months.

Credit markets have started to turn due to the current stressors. Nominal yields on U.S. corporate debt have risen quickly, returning to pre-pandemic levels in less than three months, which has kept many issuers on the sidelines. Notably, nonfinancial corporate issuance is down roughly 52% through March 16, from a year earlier. If the conflict and sanctions drag on for an extended period, risks to economic growth will rise, and inflation would likely remain elevated. A sharp widening of spreads would raise the likelihood of our pessimistic default forecast for year-end (of 6%), relative to the 3% baseline.

Volatility in financial markets has increased and borrowing costs have begun to rise. We see a high risk that investors could soon demand significantly higher returns because of an escalation in the Russia-Ukraine conflict, the continuation of historically high inflation, or other unexpected adverse events (see table 1). The latter could include a perceived Fed policy misstep, given that easing demand-driven inflationary pressures from slower growth could create a conundrum for central bankers as they look to contain supply-side price pressures. This could result in the repricing of financial and real assets, higher debt-servicing costs, and tighter financing conditions—which is

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Contents

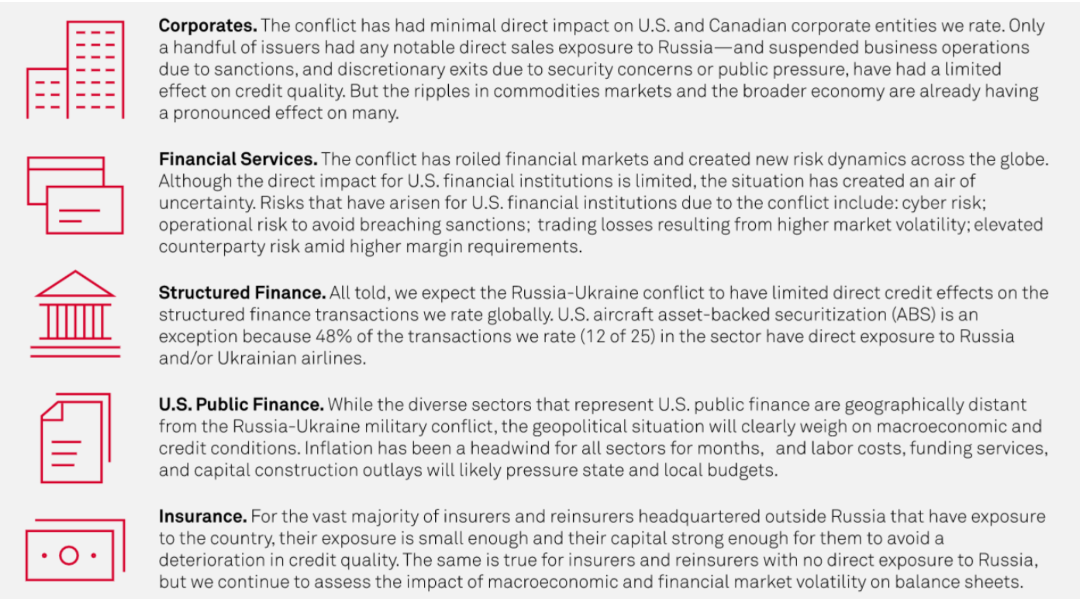
especially concerning against the backdrop of high debt levels, and could hurt lower-rated borrowers in particular. Moreover, we think this risk will likely worsen in the next 12 months.

This comes as companies continue to deal with sharply higher input costs and supply-chain disruptions that are being further fueled by the rising energy and commodities prices caused by the Russia-Ukraine conflict. Borrowers have so far relied on their ability to pass through prices to maintain profit margins, but if cost pressures don't ease—or if inflation begins to weigh heavily on demand—the resultant profit erosion could hit credit quality. For U.S. public finance sectors, too, inflation, particularly wage growth, continues to be a headwind. Without offsets in revenue, operating margins can face pressure and lead to lower debt-service coverage or create a structural imbalance. Higher costs for materials will also pressure capital plans, a focus for many issuers right now given stimulus support for projects. That said, we think this risk will likely worsen in the near term.

And although borrowers in North America have limited direct exposure to the Russia-Ukraine conflict, the turmoil in the energy and commodities markets is already hitting growth prospects and adding to recession risk (see chart 1). Continuing uncertainties around the conflict, along with other geopolitical tensions such as the strategic confrontation between U.S. and China, could further weigh on trade, capital flows, market confidence, and business conditions. We see this as a high risk that will remain unchanged (neither ease nor worsen) in the near term.

Chart 1

Impact Of Russia-Ukraine Conflict On U.S. Ratings Practices



Source: S&P Global Ratings. For U.S., Ripple Effects Of Russia-Ukraine Are More Concerning Than Direct Exposure, March 18, 2022.

On the bright side, economic activity has proved more resilient to each COVID wave. Still, the risk of further outbreaks and renewed social restrictions is ever-present. An uncontrolled resurgence of the virus could cause renewed consumer caution, curb economic activity, and exacerbate supply-chain constraints.

All told, these intersecting credit headwinds could result in pronounced downside effects.

Table 1

Top North America Risks

Investors reprice risk in response to persistent high inflation, market turbulence

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

Amid increased volatility in financial markets, investors could soon demand significantly higher returns for the risks they're assuming because of sustained high inflation, the escalating Russia-Ukraine conflict, or an unexpected adverse event. This includes a perceived central bank policy misstep, given that an easing of demand-driven inflationary pressures from slower growth could create a conundrum for policy makers. Together, this could result in the repricing of financial and real assets, higher debt-servicing costs, and tighter financing conditions—which is especially concerning against the backdrop of high debt levels, and could hurt lower-rated borrowers in particular.

Sustained cost pressures and supply chain disruptions threaten credit quality

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

Companies continue to deal with sharply higher input costs and supply-chain disruptions, further fueled by higher energy and commodities prices triggered by the Russia-Ukraine conflict. Many borrowers have relied on their ability to pass through prices to maintain profit margins, but if cost pressures don't ease—or if inflation begins to weigh heavily on demand—profit erosion could become more widespread and steeper than we expect. This, in turn, could harm credit quality.

Geopolitical tensions weigh on growth and business conditions

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

While borrowers in North America have limited direct exposure to the Russia-Ukraine conflict, the turmoil in the energy and commodities markets is already hitting growth prospects. Continuing uncertainties around the conflict could further weigh on trade, capital flows, market confidence, and business conditions. Meanwhile, the strategic confrontation between the U.S. and China looks set to continue, and rising tensions over Russia and the South China Sea region could impede trade and investment regionally and globally.

COVID crisis resurges, curbing economic activity

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

While economic activity has proved more resilient to each COVID wave, the risk of further outbreaks, and, thus, renewed social restrictions, is ever-present. An uncontrolled resurgence of the pandemic could cause renewed consumer caution, curb economic activity, and exacerbate supply-chain constraints—as with the omicron-variant spread and related lockdowns in China.

Structural Risks

Cyber attacks disrupt business operations and hurt credit quality

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

Cyber attacks pose a systemic threat and significant single-entity event risk, as new targets and methods emerge—with geopolitical tensions raising the prospect of major attacks. As public and private organizations accelerate their digital transformation, a key to resilience is a robust cyber-security system, from internal governance to IT software. Entities lacking well-tested playbooks (such as active detection or swift remediation) are most vulnerable.

Energy transition and ESG factors affect business operations, borrowing costs

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

As the focus intensifies on ESG factors, borrowers that are (or are perceived as being) risky from an ESG perspective could be forced to pay a premium to borrow or be shut out completely from the capital markets. Beyond the physical risks of climate change that many companies are subject to, the global drive toward a "net-zero" economy also heightens the transition risks (e.g., policy, legal, technology, market, reputation risks) across many sectors, and will likely require significant investments. At the same time, the energy market disruption resulting from the Russia-Ukraine fighting is adding significant uncertainty to this transition.

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 aren't 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.

Macroeconomic Outlook

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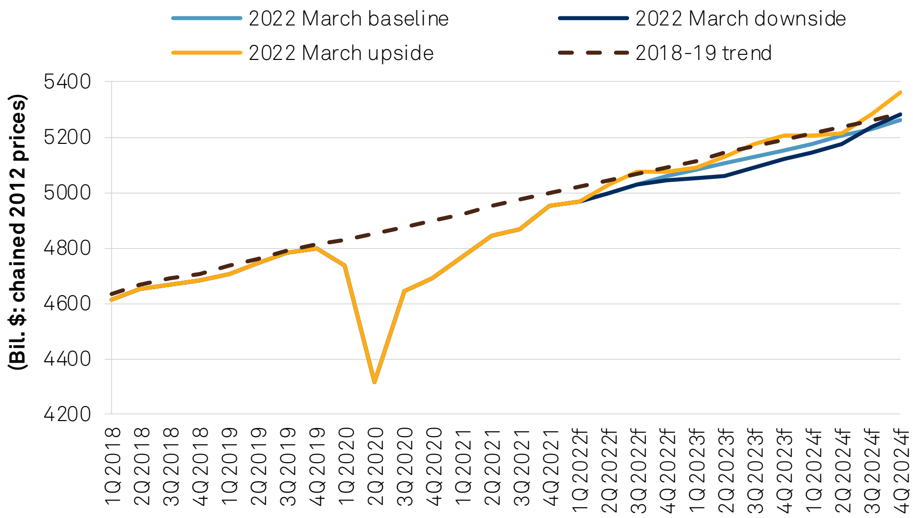
U.S.

U.S. economic conditions have shifted notably since the start of the year, with the Federal Reserve embarking on what looks to be a path of aggressive monetary-policy normalization and Russia's invasion of Ukraine having some knock-on effects. With inflation still running hot, and the Russia-Ukraine conflict underpinning price pressures, S&P Global Economics now expects U.S. GDP growth to fall 70 bps short of its earlier forecast, to 3.2% this year (see chart 2). This projection is still in expansion territory and well above the U.S. economy's potential growth rate of approximately 2%. Still, the downside risk is rising, and we now assess the risk of recession in the next 12 months as about 1-in-4 (and less likely before 2023, as successive rate hikes take effect).

Chart 2

U.S. Real GDP—March 2022 Baseline, Downside, And Upside Scenarios



f—Forecast. Sources: BEA, Oxford Economics, and S&P Global Economics forecasts.

On the bright side, the economic implications of the coronavirus crisis continue to fade. Through the omicron wave, economic and job market activity stayed resilient. The U.S. gained 678,000 jobs in February, and headline unemployment fell to 3.8%, from 4.0% in January, for all the right reasons, according to the Bureau of Labor Statistics' jobs report. More than 300,000 people entered (or re-entered) the workforce, and 548,000 workers secured employment.

Wage gains have roared to a record high, totaling 5.8% in February on a year-over-year basis, according to the Federal Reserve of Atlanta wage tracker, and the household savings rate is 6.4%, indicating that Americans are still comfortably holding onto their cash. But inflation continues to take sizable bites out of paychecks and erase real wage growth. Consumer confidence has dropped to a 10-year low and may plummet further as the Russia-Ukraine conflict drags on. We expect inflation to accelerate and average around 6% by year-end—far higher than our November forecast of 3.9%.

All of this has prompted the Fed to act, with the central bank announcing a 25-bps rate hike after its March 15-16 Federal Open Market Committee meetings. Policymakers' plans for six more increases this year and four more in 2023 show they are taking a hawkish stance to fight inflation, with risks for even tighter policy. The Fed's tapering of asset purchases ended this month, and an announcement on the strategy around reducing the size of its approximately $9 trillion balance sheet is expected later this year. S&P Global Economics now sees the benchmark federal funds rate rising 175-200 bps this year (including the March move, and with at least one 50-bps hike likely), to around 2%, and another 100 bps in 2023. We also now expect the Fed to begin unwinding its balance sheet this year, with an announcement as soon as in May.

Inflation was already running at 40-year highs before Russia invaded Ukraine—and is now worsening due to intensifying price pressures for energy, agricultural commodities, and metals. The Bureau of Labor Statistics' closely watched Consumer Price Index jumped 7.9% year-over-year (and 0.8% for the month) in February, following a revised 10% surge in January. Retail sales growth eased slightly in February, rising just 0.3% month-over-month after January's strong 4.9% rebound. Core inflation increased 6.4% year-over-year and 0.5% month-over-month. As Western sanctions drive up energy prices, limits on exports of other key Russian commodities, including fertilizer and palladium, will further exacerbate supply chain woes and hamper growth in the U.S. and elsewhere.

Canada

Canada's economy has likewise held up well. As with the U.S., the implications of the Russia-Ukraine crisis on the Canadian economy will likely be limited—but not invisible—due to lower trade and financial ties with both Eastern European countries and the economy's ability to substitute for any lost input. As such, S&P Global Economics now expects the Canadian economy to expand 3.7% this year. We also expect Canadian core CPI inflation to average 3.4% this year.

Canada's economy started 2022 fresh off last year's economic expansion of 4.6%, and activity made it through the omicron wave without much of a hit. Recent employment gains further indicate the Canadian economy's strength. The country gained 337,000 jobs in February—with 114,000 jobs in the accommodation and food services sector added mainly due to restaurants reopening in Ontario and Quebec. Canada also added 37,000 jobs in the construction sector as overall activity re-energized.

But the ripple effects of Russia's invasion of Ukraine will likely be felt in the Canadian economy via higher energy and food prices, subdued external demand, and additional supply disruptions exacerbating pricing conditions. Headline inflation jumped 5.7% year-over-year in February, up from 5.1% in January and marking the largest increase since August 1991.

High prices may force the Bank of Canada to tighten policy further than the four rate hikes we expect this year and two in 2023.

Sovereigns

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The conflict in Europe poses short- and long-term risks for the U.S. Although the U.S. has smaller direct trade ties with Russia and Ukraine than many European countries do, it will suffer from continued supply disruptions, higher inflation, slower global economic growth, and greater risk-aversion. As a result, the risk of low GDP growth and moderately high inflation (especially in energy, food, and transportation) is rising.

This complicates the Fed's path of monetary-policy normalization. On the policy front, the worsening economic panorama may result in new fiscal legislation to sustain GDP growth (though likely smaller than recent stimulus packages) and in steps targeted at sectors such as energy and transportation that are most affected by rising prices. However, we don't expect major legislative changes in the months leading up to the midterm elections in November 2022.

In the long term, the political fallout from the recent conflict may change the contours of the global economy. Harsh economic sanctions, and severed financial and trade ties, may spark long-term changes in the world's financial architecture, supply chains, trade flows, and political alliances.

Financing Conditions

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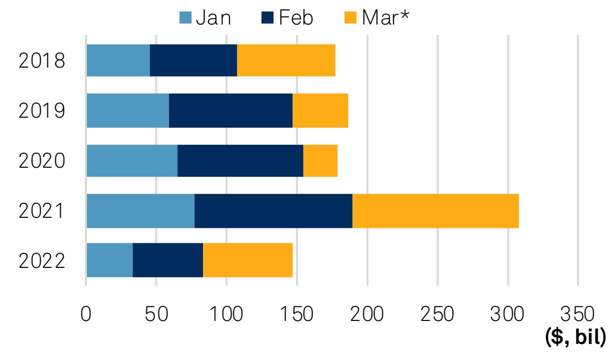
After the most-favorable financing conditions in at least 40 years during 2020-2021, credit markets have begun an about-face—kicked off by the aggressive tone of the minutes of Fed policymakers' December meeting and quickly followed up by Russia's invasion of Ukraine. The military conflict and associated strict sanctions on Russia will likely add to existing supply shortages and underpin historically high inflation—further complicating an already cloudy road for the Fed to navigate on its journey toward monetary-policy normalization.

The effect thus far has been a marked slowdown among primary bond markets, with nonfinancial corporate issuance down roughly 52% through March 16, from a year earlier (see chart 3). Meanwhile, financial services issuance is up 5% from the same period in 2021, likely benefiting from the fact that higher base rates translate to higher interest margins on borrowers' operations.

Chart 3

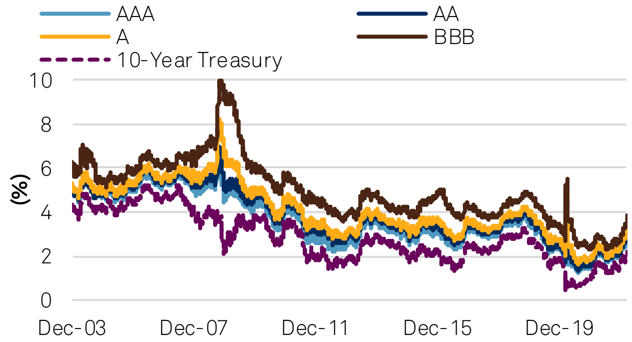
U.S. Nonfinancial Bond Issuance Slow Out Of the Gate Amid High Volatility



*Data through March 16, 2022. Sources: S&P Global Ratings; Refinitiv.

Chart 4

U.S. Investment-Grade Corporate Industrial Bond Yields



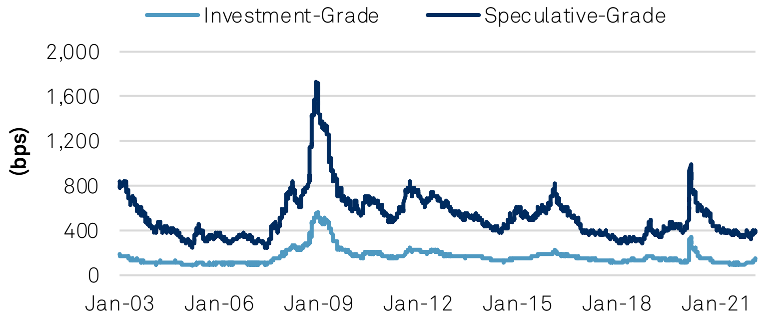
Sources: S&P Global Ratings; FRED, Federal Reserve Bank of St. Louis.

Coming into the year, we expected borrowing costs to rise from their especially low levels. However, the current stressors have accelerated private sector interest rate increases alongside increased market volatility. Indeed, nominal yields on U.S. corporate debt have risen quickly, returning to pre-pandemic levels in less than three months (see chart 4). This has kept many issuers on the sidelines, waiting for the market to find its new "level" for rates.

It appears the market volatility and rising yields are more a reflection of uncertainties around monetary policy than the Russia-Ukraine conflict. Yields have risen across the board, including on Treasuries, implying that the increases thus far are more a function of duration than reflecting prospects for a recession. So, while the nominal cost of debt has risen, the risk for corporates remains relatively benign as reflected in still subdued spreads (see chart 5). This has been particularly true for speculative-grade spreads, which finished March 16 below 400 bps, despite investment-grade spreads rising to 150 bps, from 108 bps, at the start of the year.

Chart 5

U.S. Corporate Bond Spreads



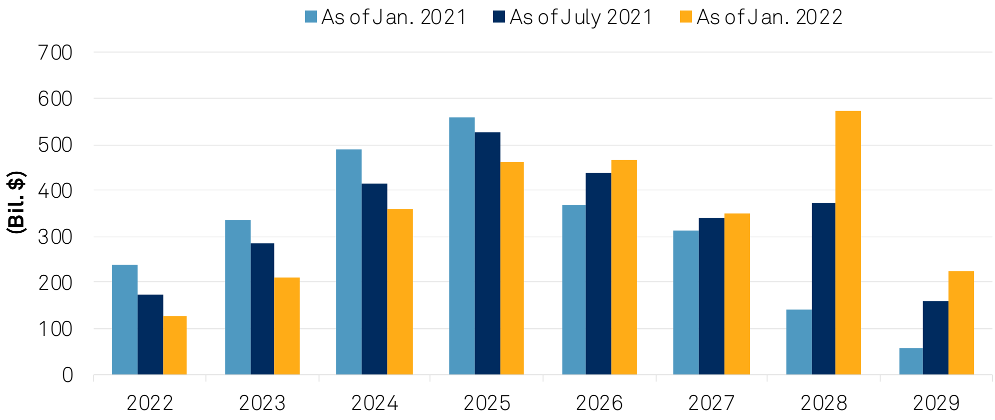
Source: S&P Global Ratings.

If the conflict and sanctions drag on, risks to economic growth will rise, and inflation would likely remain elevated. A sharp widening of spreads as a result would raise the likelihood of our pessimistic default forecast for year-end (of 6%), relative to the 3% baseline.

For now, upcoming maturities support our baseline view of defaults in the next 12 months. In the past year, companies have reduced the level of debt due this year and next, locking in low rates or longer funding commitments. In particular, there is now a longer-than-usual runway before the largest volumes of speculative-grade debt mature. Normally, the spec-grade maturity wall reaches its highest point about 4-5 years out, but after the robust conditions of 2021, nonfinancial spec-grade maturities don't peak until 2028, when $573 billion in debt is set to mature (see chart 6).

Chart 6

U.S. Corporate Maturity Wall - Nonfinancial Speculative-Grade



Note: Includes bonds, loans, and revolving credit facilities that are rated by S&P Global Ratings on the respective report date.
Source: S&P Global Ratings.

U.S. Public Finance

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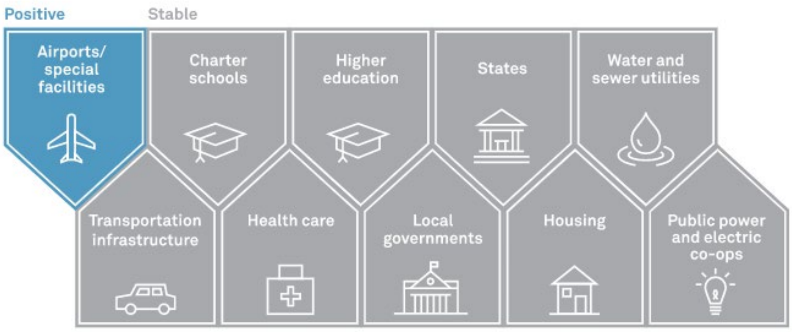
Credit Quality Remains Stable, At Least for Now

S&P Global Ratings expects credit conditions to be favorable for U.S. public finance (USPF) this year. All our sector views are stable, except the airport subsector, which is positive, and the parking subsector, which remains negative (see chart 7). The ratings distribution remains strong; negative outlooks represent about 3% of total ratings compared to about 8% at the start of 2021.

Chart 7

U.S. Public Finance Sector Views For 2022



The **Parking** sector has a **Negative** view. Source: S&P Global Ratings.

Stimulus dollars received from the federal government last year will continue to support finances across all USPF sectors in 2022. However, pressures that could put issuers off track are ramping up. The biggest credit drivers will affect sectors in different ways; what we're watching in USPF includes:

Mounting inflation. Inflation continues to be a headwind for all sectors. The longer it remains elevated the more profound the effects in the longer term, particularly for wage growth. Without offsets in revenue, operating margins can face pressure and lead to lower debt-service coverage or create a structural imbalance. Higher costs for materials will also pressure capital plans, a focus for many issuers right now given stimulus support for projects.

Effect of global markets on U.S. credit stability. Volatility in the capital markets can affect U.S. states that rely on capital-gains taxes. To the extent that market instability leads to markedly weaker financial performance, the effect can also reverberate to local governments. Fluctuating oil prices also have a wide-ranging effect on issuers and can quickly create budget pressures for those that don't have long-term supply contracts.

Rising interest rates. An elevated cost of capital limits funds available for capital projects, and the situation is exacerbated by higher materials costs. Since advanced refundings for tax-exempt debt were eliminated as part of the 2019 Tax Cuts and Jobs Act, issuers won't be able to refund for lower coupons if rates abate, and higher fixed costs will continue to pressure budgets for the foreseeable future.

Uptick in cyber attacks. USPF issuers have long been targets for cyber attacks, which can lead to credit challenges. Issuers need to be on heightened alert to safeguard against an increased risk of malware either purposefully targeted or inadvertently spread in the Russia-Ukraine conflict by bolstering systems to avert attacks and prevent credit-impactful disruptions. The rising cost of cyber insurance is making some issuers reconsider getting coverage, which would leave them more vulnerable in an attack.

Post-COVID return to office. Many downtown cores have struggled with lower daily population over the past two years and are eager for commuters to return. What a "new normal" looks like in commuting patterns remains to be seen, but stabilization in downtown tax bases and a boost to transit operations could be two short-term gains.

Nonfinancial Corporates

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With Russia accounting for less than 3% of the global economy, the military conflict and associated sanctions have had only small direct effects on U.S. and Canadian corporate entities we rate. Borrowers' sales exposure to Russia is generally very small, and operations suspended due to sanctions, along with discretionary exits due to security concerns or public pressure, have had a limited impact on corporate credit quality (see table 2).

Table 2

Impact Of Russia-Ukraine Conflict On Credit Quality Of North American Corporates By Sector

Sector	Impact	Likelihood	Rated debt (bil. US$)
Aerospace and defense	Neutral	Medium	329
Autos	Negative	High	476
Capital goods	Negative	Medium	561
Chemicals, packaging, and environmental services	Neutral	Medium	560
Consumer products	Negative	Medium	1,320
Forest products and building materials	Negative	Medium	225
Health care	Neutral	High	1,368
High technology	Neutral	Medium	1,419
Homebuilders/real estate	Negative	Low	430
Media and entertainment	Neutral	Medium	1,482
Metals, mining, and steel	Positive	High	178
Oil and gas	Positive	High	560
Retail/restaurants	Negative	Medium	850
Telecommunications	Neutral	Medium	1,374
Transportation	Negative	High	429
Utilities	Neutral	Medium	1,917

Note: Impact—The type of rating pressure we anticipate as a result of direct and indirect consequences from the Russia-Ukraine conflict. For each sector we incorporate our outlook as well as how well issuers are positioned to sustain ongoing macroeconomic and operational challenges. Likelihood—Our general confidence level that the impacts we expect will materialize with the magnitude or duration we anticipate. Rated debt data is as of March 15, 2022. Source: S&P Global Ratings.

However, turbulence in commodities markets, in particular, can't be ignored. Soaring energy costs (Russia is the world's third-largest oil producer) and rising prices on agricultural products (given the amount of wheat, barley, corn, and fertilizer from the region) are underpinning already high inflation. On top of that, companies will likely face additional input-cost pressures as air-traffic interruptions and limited access to the Black Sea exacerbate supply bottlenecks. While the demand premium for goods and services has allowed many companies to pass along cost increases, their ability to raise prices to offset them is finite, especially if demand and confidence wane. In the near term, these pressures could shrink profit margins in some sectors and—if conditions get bad enough—begin to weigh on credit quality (see chart 8).

Russia is a large producer of aluminum, nickel, and, most notably, palladium—and prices for these metals soared in the aftermath of the invasion (although most have since retreated). Normally, this would result in increased supply from North American metals and mining companies—but there are many hurdles to overcome. Palladium reserves, for example, are relatively scarce, and alternative sources just aren't sufficient to completely offset Russian exports in a cost-effective way. Also, energy is a key input in metals mining and processing of metals.

On the flip side, while countries that depend heavily on Russian oil and gas are accelerating their efforts to diversify, American and Canadian oil and gas companies stand to benefit from rising prices—and we are already seeing examples of widening margins.

Similarly, with sharply higher prices for agricultural commodities and other crop inputs such as fertilizers, the disruption of supply from Russia and Ukraine could ultimately be credit-positive for some North American agribusiness companies, such as grain processors. But constraints on Russian exports of certain fertilizers could hurt farmers in the longer term unless they find alternative sources, which we believe is unlikely. Fertilizer shortages could crimp future harvests, and volatile prices will make it more challenging to plan ahead.

Chart 8

Pass-through Ability And EBITDA Margins Trend By Sector

Average EBITDA Margins in 2022 vs. 2021

Question: Reflecting your assumptions for costs, product mix and any other relevant factors, how do you expect average EBITDA margins to develop for 2022 versus 2021?

Cost Pass-through Ability — Question: How easy is it to pass on cost increases?

	Rise a lot	Rise moderately	Rise a little	Fall a little	Fall moderately	Fall a lot
Very easy		• Out-of-home entertainment		• Metals & mining • Regulated utilities		
Somewhat easy	• Airlines • Cruise • Lodging	• Aerospace & defense	• Containers & packaging • Leisure manufacturing • Oilfield services • Pharma • REITs • Technology	• Building materials • Capital goods • Chemicals • Engineering & construction • Freight transportation • Gaming • Homebuilders • Telecom • Unregulated power	• Autos	
Impossible to generalize	• Oil and gas E&P			• Business & consumer services • Midstream energy • Oil refineries		
Somewhat difficult				• Healthcare services • Retail & restaurants	• Film and TV programming production	• Consumer products
Very difficult						

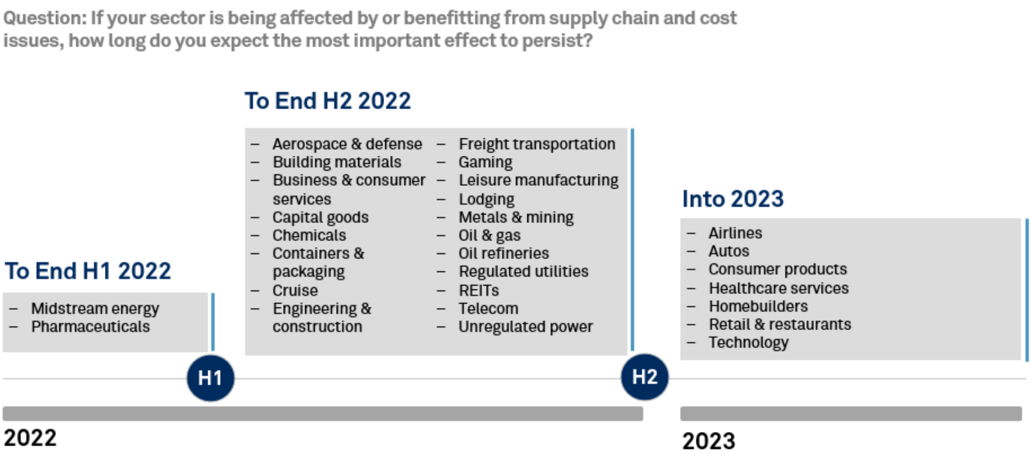
Source: S&P Global Ratings' corporate sector analysts' assessment as of March 22, 2022.

Auto makers, too, are feeling the effects. Global supply disruptions and inflation due to raw-materials scarcity is a critical risk for the industry. Specifically, the effects from the disruption of critical automotive parts from the region, potential shortages for materials such as palladium, and high steel, copper, and nickel prices represent key industry risks. This is adding to ongoing supply-side risks related to the semiconductors shortage, which shows no relief in sight until at least 2023 (see chart 9); we've therefore lowered our estimates for auto sales and production growth.

More directly, the military conflict and sanctions on Russia will affect the aircraft lessors we rate. The sanctions prohibit providing aircraft and aircraft parts to Russia, and this applies to aircraft leases. The repossession of hundreds of aircraft affected will be a major logistical undertaking, but our understanding is that prohibitions on Russian planes entering the air space of certain other countries either wouldn't apply to repossession flights or could be circumvented by flying to other destinations outside Russia. More broadly, the run-up in oil—and, thus, jet fuel—prices will hurt airlines around the world.

Chart 9

Most U.S. Sectors Expect Supply Bottlenecks To Linger At Least Till The Second Half Of 2022



Source: S&P Global Ratings' corporate sector analysts' assessment as of March 22, 2022.

Structured Finance

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The North American structured finance credit picture remains generally stable, buoyed by GDP growth and employment gains (see table 3). Sustained inflation could hit both consumer and some commercial sectors, but is mitigated somewhat in the near term through its positive effect on asset prices, a build-up in household saving rates during the pandemic, low interest rates, and generally positive macroeconomic trends. Increasing oil—and, thus, gasoline—prices are a wildcard for their potential to lower growth rates and exacerbate inflation. Further, we have seen more caution regarding new debt offerings, with some issuers hesitant to come to market amid widening spreads and a more uncertain environment—especially regarding longer-dated assets.

That said, we expect the Russia-Ukraine conflict to have limited direct credit impact on the structured finance transactions we rate globally. U.S. aircraft asset-backed securitization (ABS) is an exception because almost half the transactions we rate (12 of 25) in the sector have direct exposure to Russia or Ukraine. We will continue to monitor transactions for any indirect effects (see "**S&P Global Ratings Expects The Russia-Ukraine Conflict To Have Limited Direct Impact On Global Structured Finance**", published March 3). For the medium to longer term, we are also monitoring the potential effects of sustained inflation on borrowers with weaker credit scores for any ramifications on our rated transactions.

Table 3

Q2 2022: 12-Month N.A. Structured Finance Outlook

	Collateral performance outlook	Rating trends
Residential mortgages		
RMBS	Somewhat weaker	Stable
RMBS - servicer advance	Somewhat weaker	Stable
Commercial mortgages		
CMBS - N.A. conduit/fusion	Stable	Stable
CMBS - large loan/single borrower	Stable	Stable
CMBS - large loan/single borrower (retail)	Weaker	Stable to negative
CMBS - large loan/single borrower (lodging)	Somewhat weaker	Stable to negative
CMBS - large loan/single borrower (office)	Somewhat Weaker	Stable to negative
Asset-backed securities		
ABS - prime auto loans	Stable	Stable to positive
ABS - subprime auto loans	Somewhat weaker	Stable to positive
ABS - auto lease	Stable	Stable
ABS - auto dealer floorplan	Stable	Stable
ABS - credit cards	Somewhat weaker	Stable
ABS - unsecured consumer loans	Somewhat weaker	Stable to negative
ABS - FFELP student loan	Somewhat weaker	Stable
ABS - private student loan	Stable	Stable
ABS - commercial equipment	Stable	Stable
Asset-backed commercial paper	Stable	Stable
Structured credit		
CLOs	Somewhat weaker	Stable
Timeshares	Stable	Stable
Small business	Stable	Stable
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	Stable	Stable

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

For commercial mortgage-backed securities (CMBS), the picture remains mixed by property type. Despite some improvement in the retail sector, we believe class B and C malls in secondary and tertiary locations will continue to perform worst. The lodging sector is improving, and group/business demand should begin to recover in earnest as omicron fades. Anecdotal reports suggest that March is a key month for return-to-office plans, and we expect to see more data points (and perhaps more clarity) during the next few quarters. We noted in a recent article focused mainly on the Manhattan office market that leasing activity has slowed and concessions are currently elevated (see "**U.S. CMBS: Remote Work And The Evolution Of Manhattan's Office Market**," published Feb. 3). Industrial, multifamily, and self-storage are among the top performers when measured by price appreciation (per Green Street CPPI) and (low) CMBS delinquency levels.

We saw record issuance of collateralized loan obligations (CLOs) last year, but the pace has slowed somewhat, with issuance remaining steady but slower amid the transition away from LIBOR and market volatility associated with the Russia-Ukraine conflict. We are watching a modest deterioration in recovery ratings that could affect some pre-pandemic CLOs, and a historically high proportion of 'B-' rated obligors in recent vintages. On the other hand, the speculative-grade corporate default forecast—even in our pessimistic scenario—is relatively low, a plus for CLO credit. We maintain a stable view of ratings trends for the next 12 months.

On the residential mortgage-backed securities (RMBS) side, market dynamics suggest home prices will increase this year, although the pace may slow. We expect the 30-year fixed mortgage rate to increase, and, coupled with home price growth, this could lead to substantially higher monthly principal and interest payments on new mortgages. All in all, we maintain a somewhat weaker stance for collateral performance overall, and a stable rating trend.

Recent consumer ABS performance trends remain mostly positive. Vehicle-price appreciation is buoying the auto ABS sector, largely due to limited new vehicle supply. However, sharply higher gas prices could damp consumer confidence, and pressure budgets and spending. Vehicle shortages notwithstanding, higher gas prices could also weigh on historically high values in the new- and used-car markets. Credit card performance metrics have been very strong, with below-average delinquencies and charge-offs, as well as significant seasoning, which may normalize over time. Nontraditional ABS remains mostly stable, with pockets of weakness in aircraft and tobacco (see "**S&P Global Ratings Reviews Aircraft ABS Exposure To Russian And Ukrainian Airlines**," published Feb. 28, and "**28 Ratings From Seven Aircraft ABS Transactions Placed On Watch Negative On The Russia-Ukraine Conflict**" and "**Credit FAQ: Impact Of The Russia-Ukraine Conflict On Aircraft ABS Securitizations**," both published March 15).

With respect to LIBOR transition, upward of 90% of legacy U.S. structured finance exposure is concentrated among the CLO, legacy RMBS, and student loan ABS sectors. The actual "phase out" deadline isn't until June 2023 for all key dollar settings. On March 15, the federal government enacted the Consolidated Appropriations Act of 2022, which included the Adjustable Interest Rate (LIBOR) Act. This law provides significant support to legacy LIBOR contracts, many of which are difficult to amend. It provides significant support to the securitization sector by minimizing legal uncertainty over interest-rate changes and enabling a consistent rate-replacement mechanism across many types of contracts. This is particularly helpful for consumer securitizations whose underlying assets are governed by many state laws. The law creates a legal safe harbor for transaction participants that choose a SOFR-based rate, which all but assures SOFR as the primary rate replacement in the 2022-2023 transition. An additional clarification was added to the law providing that banks may use benchmarks that aren't SOFR-based and further that no federal supervisory agency may take action against them solely because the rate they have used isn't based on SOFR. This may have relevance in the corporate loan sector where some small to midsized banks have expressed interest in using credit-sensitive rates instead of LIBOR.

Financial Institutions

Banks

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On balance, we continue to have a constructive outlook for U.S. banks in 2022. We expect that higher interest rates and low credit costs will be favorable for earnings, tempered somewhat by persistently high inflation crimping bank borrower finances or the potential for second-order effects from the Russian-Ukraine conflict. Positively, we believe bank regulation has improved greatly since the Global Financial Crisis (GFC) of 2008-2009, and the balance sheets of U.S. banks look as strong as they have in many years. We believe the regulatory and supervisory enhancements implemented since the GFC benefited banks' financial performance leading up to and during the pandemic. Based on this, we may revise the anchor for our ratings on banks in the U.S. to 'A-' from 'BBB+' in the next 1-2 years, which could result in higher ratings on some banks.

U.S. banks reported strong fourth-quarter 2021 results compared with a year earlier, benefiting from lower credit provisions, strong capital markets and fee revenue, and some growth in net interest income (see "**For U.S. Banks, A Revenue Boost In 2022 While Profitability Will Lag**," published Feb. 16). As the Fed raises interest rates, it should boost banks' net interest margins from multidecade lows, which should help revenues, offset a sizable increase in provisions for credit losses, rising wages, and technology spending, as well as pressures on some sources of fee income. All in all, we expect the industry to report a return on equity of 9%-10% in 2022, supported by a roughly 10% rise in net interest income (see "**When Rates Rise: Tighter Monetary Policy Will Provide A Lift To U.S. Banks**," published Feb. 10).

U.S. banks' direct exposure to Russia and Ukraine is limited. According to the Bank for International Settlements (BIS), U.S. claims on an immediate counterparty basis to Russia total $14.7 billion, with $7 billion in local currency. Per data from the Federal Financial Institutions Examination Council, no American bank has exposure to either of these countries that exceeds 0.75% of assets or greater than 15% of capital. Still, we believe U.S. banks could see some second-order effects from heightened geopolitical risk. Specifically, counterparty risk for institutions with more direct exposure to these countries could rise, as could cyber/operational risk given the placement of sanctions, and that higher-than-normal volatility in financial markets could generate trading losses. In addition, if interest rates stay lower-than-expected due to a protracted conflict, this would also pressure bank earnings.

Finance companies

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We have stable outlooks on most finance companies we rate. In general, asset quality remains favorable on the heels of the strong economic recovery from the pandemic. Although market conditions weakened due to the conflict in Ukraine, finance companies took advantage of favorable financing conditions throughout 2021 to refinance near-term debt and extend their funding profiles, while taking advantage of low-cost funding. We continue to have stable outlooks on all business development companies (BDCs) we rate. We will monitor the effects of rising interest rates and inflation on portfolio companies, but don't expect significant asset-quality deterioration in the near term. Direct exposure to Russia and Ukraine is minimal for BDCs and other U.S. finance companies, but we will monitor for any ripple effects on their loan portfolios.

Last year, we revised our outlooks on most rated commercial real estate (CRE) finance companies to stable from negative. We think the likelihood of substantial further deterioration in CRE finance companies' loan portfolios has lessened. As the omicron variant recedes and workers return to the office, this should relieve some pressure on some of the most affected property types, such as office properties and hotels in central business districts.

For consumer finance companies, we generally have stable outlooks. Overall, performance in the consumer finance segment was surprisingly resilient during the pandemic-related shutdowns, although we expect some normalization of asset quality in 2022, particularly related to lower-income consumers who may be most affected by rising prices.

Performance at residential mortgage companies will be affected by the 30-year mortgage rate. We expect Fed rate hikes will hurt both margins and volume following two years of relative overperformance. Although we expect market conditions to normalize in 2023, we could see negative rating actions if weak conditions persist longer than expected.

Asset managers

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We have stable outlooks on most asset managers we rate, which include traditional and alternative asset managers as well as wealth managers. In general, asset prices still benefit from the strong economic recovery, providing continued support to assets under management (AUM) levels and margins. That said, market conditions have weakened recently due to the conflict in Ukraine.

There is no elevated direct exposure to Russia-Ukraine for the larger asset managers we rate. However, we are monitoring any second-order effects on valuations, AUM flows, earnings, and profitability as these could be affected by rising rates and inflation.

We expect traditional asset managers to continue to face pressures from secular shifts including active to passive. While wealth managers and traditional asset managers may be similarly vulnerable to market movements, we expect a potentially stickier asset base within wealth manager's clients—as many of these (generally high-net-worth) retail investors value the services offered. We continue to believe alternative asset managers remain relatively well-positioned due to largely locked-up AUM and strategies that are harder to index. Alternative asset managers have enjoyed significant net inflows due to good investment returns as investors searched for yield. As such, we have seen a general expansion in the size of average funds and broadening platforms. That said, we believe risks for alternative asset managers remain, as any material, protracted valuation declines could hit returns and overall performance. Although we expect market conditions to normalize by 2023, we could see negative rating pressure if weak conditions persist longer than expected or are sharper than we expect.

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While recent ratings changes have been very limited, we have revised our business conditions outlook assessment for the life sector (downward to no change from somewhat stronger) and the health sector (upward to somewhat stronger from no change) (see table 4).

Overall, the average financial strength rating for the core North American insurance portfolio (life, health, property/casualty [P/C]) resides at the upper half of the strong ('A') category amid a slight reduction in credit quality for the P/C sector due to a change in the portfolio mix. In addition, a high percentage (85% or better) of our ratings assignments for the core portfolio maintain stable outlooks with the emergence of a modest negative bias for the life and P/C sectors and a modest positive bias for the health sector. The relatively lower-rated mortgage insurer portfolio ('BBB+') continues to reflect a positive outlook bias.

For the vast majority of insurers and reinsurers headquartered outside Russia that have exposure to the country, their exposure is small enough and their capital strong enough for them to avoid a deterioration in credit quality.

Major ratings factors include natural catastrophes, investment yield, regulatory and legislative policy, higher claim costs (inflation-driven), and competition. Financial conditions remain accommodative, as borrowing costs haven't increased enough to materially affect issuers, which in general aren't highly leveraged. Balance-sheet strength remains a pillar of credit quality, providing some protection from risks related to downside economic developments broadly and the expansion or increase in the magnitude of existing and emerging subsector risks more specifically.

Table 4

North America Insurance Sector Trends Q2 2022

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

Note: Business conditions and sector outlook are for the next 12 months. The shaded cells indicate changes since Q1 2022.
Source: S&P Global Ratings.

The past year has been positive for life insurers, powered primarily by strong investment returns, strong growth in life and annuity sales, and rising equity markets—balanced by manageable mortality effects from COVID. The pandemic still creates much uncertainty, albeit less than in the past. Life and annuity sales growth was especially strong last year, likely influenced by pandemic-related issues such as pent-up demand and mortality being top-of-mind for many people. These drivers will likely moderate or dissipate going forward, so we believe sales growth this year will be less dramatic. Low interest rates continue to be a concern for the industry, although life insurers have been able to adapt their product portfolios and investment policies to deal with this as well as they can. The low-rate environment will likely continue to fuel mergers and acquisitions. We believe companies will continue look to for opportunities to exit and/or divest nonstrategic business blocks and simplify their balance sheets. The overall positive trajectory the industry was on last year may continue, but likely be more subdued, with lower sales growth, stable capital levels, and reduced earnings compared to last year.

For health insurers, the economic recovery will bolster employer-sponsored commercial membership this year, although in-group gains may take time to show up given many employers' retention/recruitment difficulties. The industry is closely watching when the Biden Administration will end the official public health emergency, as it will mean the restart of Medicaid redeterminations, which will result in membership losses. The industry continues to frame COVID as an overall earnings headwind. Insurers have cited omicron, higher non-COVID utilization, and OTC COVID-19 costs as factors that will damp 2022 earnings.

Underwriting profitability of U.S. P/C insurers remained solid last year with the industry's combined ratio (claims-related losses plus expenses/earned premiums) anticipated to be about 99%, essentially unchanged from 2020 despite elevated catastrophe losses and inflationary challenges. Strong rate momentum for most commercial lines exceeded loss-cost trends, resulting in further margin expansion. Rate increases should slow, but margin expansion is expected to continue. Offsetting this strength to some extent was deterioration in personal lines, which came under pressure from the spike in the cost of building materials, car parts, and wages. Personal auto insurers are pursuing substantial rate increases as they attempt to catch up with rising claims costs, so their results should improve. Overall, we expect underwriting performance this year—assuming a normal level of natural catastrophe losses—to be similar to 2021. Low interest rates remain a damper on net investment income, but this was offset to some extent by strong returns on alternative investments and gains on public equities. Capital adequacy has been a relative strength to our ratings on most P/C insurers. We expect this to remain the case, although rising interest rates reduced the unrealized gains on bond portfolios.

The global reinsurance sector has struggled to earn its cost of capital in the past several years and the trend could continue. Underperformance was driven by COVID and large catastrophe losses, adverse loss trends in certain U.S. casualty lines, and lower investment returns. In addition, fierce competition among reinsurers exacerbated by alternative capital, which over the years has eaten up margins in the property-catastrophe sector. As a result, our outlook on the sector has been negative since May 2020, but we may revise our view back to stable if we believe reinsurers can sustainably earn their cost of capital. Capitalization remains robust benefiting from capital raises in the past two years, and financial markets recovery since the onset of the pandemic. As a mitigating factor, reinsurance pricing has been hardening during the past couple of years, with tightening terms and conditions, further supported by COVID and catastrophe losses. Many global and regional reinsurers may have exposure to Russia. However, we believe their exposure is limited relative to their assets/existing liabilities. So, we continue to monitor the effects of this conflict on the global reinsurance sector.

Bond insurers closed out 2021 with the total dollar amount of new issue U.S. municipal par insured reaching a level not seen in more than a decade. As a result of the pandemic, investors' heightened focus on credit quality, trading value stability, and market liquidity pushed demand of bond insurance and the trend appears set to continue. Additionally, secondary-market insurance demand continues as institutional investors use bond insurance as a risk-mitigation tool. The quality of business written has remained stable at 'A-' in the past two years. While investor demand for insurance in the USPF market may be higher than in recent years, the low-rate environment could pressure risk-adjusted pricing. Bond insurers will need to adhere to the pricing discipline they have displayed in the past to ensure the long-term profitability.

The title sector continues to benefit from rising homeownership, notwithstanding a demand-supply imbalance, a stronger CRE market, and supportive sector capitalization. In addition to an overall increase in applications, revenue growth is due to higher revenue per order due to strong home-price appreciation and more larger commercial transactions. The overall financial strength of title insurers will depend on their ability to manage operations throughout the mortgage cycle, as well as employ proper risk and underwriting controls during periods of high business volume. Each company we rate has proven successful at expense control and setting risk-tolerance standards.

Private mortgage insurers (PMIs) continue to benefit from the economic recovery, borrower forbearance relief, the robust housing market, and adequate capitalization supported by access to reinsurance. While risks persist as the borrower's forbearance period ends, we believe that any stress will be an earnings event for the sector rather than a capital one. Mortgage originations remain robust, partly due to higher refinancings. However, as interest rates rise, refinancings will likely slow toward historic levels. As a result, we expect persistency levels (lower lapse rate) will improve and support PMIs' portfolio growth. We expect the recovering economy will support our improving earnings outlook. Under our base case, we expect the sector's combined ratio will be 30%-35% this year and 28%-33% in 2023. Delinquency rates should continue to moderate. However, we temper our earnings expectation due to the sensitivity around the transition period when payment forbearance subsides, and the extent of its impact on cure rates.

Related Research

- Credit Conditions Asia-Pacific Q2 2022: A Divide Takes Shape, March 29, 2022
- Credit Conditions Emerging Markets Q2 2022: Conflict Exacerbates Risks, March 29, 2022
- Credit Conditions Europe Q2 2022: Seismic Shocks, Security & Supply, March 29, 2022
- Economic Outlook U.S. Q2 2022: Spring Chills, March 28, 2022
- Economic Outlook Canada Q2 2022: Growth Forecasts Hold Up As Global Risks Rise, March 28, 2022
- For U.S., Ripple Effects Of Russia-Ukraine Are More Concerning Than Direct Exposure, March 18, 2022
- U.S. Financial Institutions Ratings See Some Indirect Increased Risk From The Armed Conflict In Ukraine, March 17, 2022
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- When Rates Rise: Tighter Monetary Policy Will Provide A Lift To U.S. Banks, Feb. 10, 2022
- U.S. CMBS: Remote Work And The Evolution Of Manhattan's Office Market, Feb. 3, 2022
- Credit Outlook For U.S. Public Finance: Positive Momentum Continues, Jan. 26, 2022

Appendix 1: Nonfinancial Corporate Sectors Outlook

For analytical contacts, please see Appendix 3.

Table 5

North America Nonfinancial Corporate Sectors Outlook

Sector	Comment
Aerospace and defense	We expect most companies to see growth in revenues and earnings in the next few quarters as higher air travel in certain markets (e.g., U.S. domestic, trans-Atlantic) drives increased demand for aftermarket parts and services, widebody production rates stabilize at low levels, and companies benefit from cost-reduction efforts. Widebody production is unlikely to increase until at least 2023 and requires more countries dropping pandemic-related restrictions on international travel. For Boeing, the key is also to resume deliveries of the 787, currently held up while the company addresses manufacturing quality issues to the satisfaction of the Federal Aviation Administration. Production of the Boeing 737 MAX should continue to increase as it recovers from the grounding, and Airbus plans to increase A320 production later this year. Russia isn't a large market for either Boeing or Airbus, and both have suspended business there. Cash flow should also improve, helping liquidity, but will remain weak or negative for most commercial aerospace suppliers as they operate at suboptimal production rates. The biggest risk is a resurgence of the virus or a new variant that causes the recovery in air travel to slow or even reverse. The second-biggest risk is weak suppliers not being able to invest in working capital and workers to support increasing production rates. Defense demand won't likely surge because of the Russia-Ukraine conflict, but the conflict helps take downside risk off the table. Certain sectors already considered key (intelligence, reconnaissance, cyber) will be even more in demand.
Autos	Credit quality in the sector will likely weaken slightly in the next 12 months as inflation headwinds offset the combined effects of slightly better year-over-year supply levels after semiconductor shortage-related production disruptions in 2021. Key drivers for steady metrics for many issuers will be sustained consumer demand, improved inventory management, better factory utilization, and the ongoing favorable product mix (more pickup trucks and SUVs, together classified as trucks) than in previous years. The economic consequences of the fighting in Ukraine add to ongoing supply-side risks related to the shortage of semiconductors. We now see a material threat to our previous base case for moderate growth in sales and production this year and have revised our estimates downward. Global supply disruptions and inflation due to raw-materials scarcity are critical risks for the industry. Specifically, the impact from the disruption of critical auto parts from the region, including wire harness manufacturing in Ukraine, potential shortages for materials like palladium and price hikes for steel, copper, aluminum, and nickel represent key industry risks. In our view, the combined effects of marginally higher volumes and higher pricing may not fully offset cost inflation. As a result, we expect to see pressure on margin and cash flow generation in the next two years.
Building materials	We expect end markets demand to remain solid at least through first half, supported by strong backlogs. We expect some margin headwinds for a sector that relies on the pass-through of volatile commodities costs for earnings. We expect distributors to maintain good flexibility to pass on pricing increases but general building materials issuer to face more headwinds, including higher labor costs. Working capital typically consumes cash for working capital in the first half of the year, releasing cash later in the year, so that record commodity prices will exaggerate this volatility. About 80% of ratings have stable outlooks. Despite strong earnings, debt leverage for the sector remains elevated due to leveraged buyouts, dividend recaps and acquisition activity.
Capital goods	The credit outlook in U.S. capital goods has stabilized with solid demand and generally good pass-through of higher costs in 2021. Persistent elevated costs and supply disruptions are testing the pricing power of manufacturers of capital goods. Demand remains strong for machinery, with high industrial output driving replacement volumes, while onshoring and infrastructure investments lay a foundation of longer-term projects. Commodities costs remain elevated, with potential shortages apparent for some meaningful inputs like nickel for stainless steel, or oil and gas feedstocks for plastics. As such, issuers are relying on competitive advantage to ensure cost pass-through and nimble operations to source scare inputs.
Chemicals	The outlook continues to remain stable. Our expectation for favorable demand and domestic/global GDP growth, combined with some cushions built up in credit metrics at many companies contribute to this view. Overall sector margins may decline slightly, but not to an extent that hurts credit quality at most companies. Cost pressures will rise for almost all. There are varying levels of capabilities within the sector to pass through these pressures. Many specialty companies and some basic commodity producers (fertilizers, some petrochemicals, titanium dioxide) could see margins rise because their

	selling prices are rising more than their costs. Many commodity-chemical companies—not involved in these basic chemicals—will pass on a large portion, but not necessarily, all their costs and see margins decline somewhat. A few companies especially those with weaker market positions (mainly at the lower end of the rating scale) will see margins fall. Rising working capital requirements caused by higher input costs could test liquidity at lower rated credits.
Consumer products	Inflation continues to be the biggest risk in the consumer space. The Russia-Ukraine conflict exacerbates an already difficult position for many companies trying to cover increasing costs by passing on inflation. The prospect of weakening consumer sentiment/spending threatens the topline. We believe margins will continue to be pressured. Ratings pressure will initially be most acute in spec-grade packaged foods.
Containers and packaging	We have a stable outlook for containers and packaging sector despite our expectations of continued operating challenges. We expect margins to be slightly improved as cost pass-through mechanisms begin to catch up to high and persistent inflationary pressures as raw-materials costs begin to level out—although we expect stronger gains in the second half as inflation continues to remain a concern. Other operating costs, including labor, logistics, energy, and supply chain issues, have affected the industry will continue to add to volatility this year, and the conflict in Ukraine will likely have far-reaching effects and add further unpredictability, particularly in the near term. Still, packaging demand continues to be strong, which should give issuers more power to attain additional price to offset further inflation. We also expect capital spending to be slightly elevated this year as such strong demand has incentivized many issuers to invest further in capacity expansions.
Gaming, leisure, and lodging	The overall outlook for the sector is stabilizing despite omicron's negative impact. About 40% of ratings outlooks are negative, but that's significantly lower than a year ago. Hotel sector profitability and credit measures will likely improve this year as business and group travel recovers, fitness may begin to recover members, revenue and profitability in a sustained fashion, and outdoor recreation and theme park revenues and EBITDA will likely continue to grow, following big gains in 2021. For many regional gaming operators we're assuming revenue and EBITDA will decline moderately compared to 2021 (but remain higher than in 2019) due to the potential hit from lower stimulus-related savings, as well as higher gas prices and cost inflation that results in some moderation of very strong 2021 margins. Additional risks include the drag of rising fuel costs on the presumed strong profit recovery of cruise lines, which still have a good forward booking pace for the second half that is in line with, and for some itineraries, compares favorably to 2019. Also, China's zero-COVID policies have caused us to significantly reduce our 2022 gross gaming revenue forecast, and the revenue stress on Macau focused gaming operators this year will likely be severe.
Health care and pharmaceuticals	Our outlook for the healthcare sector remains stable, with a positive bias. Many major players have successfully navigated the pandemic, with higher average acuity levels (due to the pandemic) resulting in higher margins, efficiency measures being taken, and federal money providing support. Non-COVID patient and procedure volumes have also largely recovered. However, the industry faces some headwinds, such as labor (e.g., nurses) costs and supplies inflation. Also, acuity levels are expected to decrease, putting some pressure on growth and margins. For pharmaceuticals, our outlook is negative, but bias is improving, highlighted by a number of recent high-profile outlook revisions to stable from negative, such as on Bristol-Myers and Eli Lilly. Pricing and research-and-development productivity remain key challenges. However, legislative risk, such as Medicare drug-pricing reform proposals, have lessened. The resolution of some high-profile industry litigation, such as the opioid-related litigation, has also helped ease pressure on ratings.
Homebuilders	We maintain a positive rating bias in the U.S. homebuilding sector, with 37% of ratings on positive outlook. Positive rating actions continued into 2022, with several outlook revisions to positive because financial discipline before and during the pandemic is yielding stronger ratios and a growing credit buffer. We expect rate hikes to damp price growth modestly but demand to remain strong given the industry's positive long-term demand, stronger pricing amid tight supply, and still-low mortgage rates, good cost management, and judicious capital allocation. Builders are managing the pace of deliveries given supply chain constraints and higher costs, some have revised their production guidance down, which confirms the industry's message of tight labor and land for the past few years.
Media and entertainment	Media companies continue to increase spending on film and TV content for their direct-to-consumer streaming services, which will pressure EBITDA and cash flow, with uncertain subscriber growth. We expect TV subscribers will continue to decline as users move toward streaming alternatives, which will increase pressure on the legacy TV model (linear networks and cable bundles). The advertising market is robust, led by digital growth, while advertising for most of traditional media has recovered from the pandemic and is holding up (TV, billboard). We expect digital advertisers will remain acquisitive while local TV companies will likely focus more on shareholder returns as the regulatory framework makes M&A more difficult. We expect outdoor and radio advertising will continue focusing on bringing down leverage as they were affected more by the pandemic.

	Out-of-home entertainment (theaters, live events) continues to recover. The effects of COVID variants has been more muted, and there is pent-up demand. As the sectors continue to recover, there is focus on improving credit metrics, but this could take until 2023 or beyond.
Metals and mining	The confirmation of financial policies and growing credit buffers portend the most upgrades in a decade in the capital-intensive metals and mining industry. We've had a positive outlook on about 15% of credits for about a year, and cash flows look strong early on, and this outlook bias could translate into upgrades on 5%-10% of the global portfolio if supportive conditions hold. Steel and aluminum producers in North America and gold producers around the world have seen improving credit quality for a few years. Coal producers, meanwhile, are benefiting from sharply higher prices, so that higher credit ratings depend on competitive prospects like product and demand horizon, as well as financial capacity to fund obligations amid declining sources of capital.
Midstream energy	The North American midstream-energy industry's credit quality strengthened last year, rebounding from the effects of the pandemic and subsequent credit stress. The economic reopening and surge in demand, coupled with broader supply issues and rising inflation, caught producers and midstream companies alike somewhat flatfooted. Domestic upstream producers have remained disciplined, living within cash flows, which has led to more modest growth expectations but high utilization rates in the most favorable basins such as the Delaware and the Appalachian. We expect modest capital-spending increases, primarily among the large, diversified companies that are finishing multiyear growth initiatives or small bolt-on organic growth projects. Companies that are more volume-dependent are spending modestly to maintain current volumes or to expand processing capacity in areas with higher natural-gas volumes. Most of this spending with be funded internally, protecting balance sheets. Liquidity is adequate across ratings, although weaker issuers in the 'B' category may find it harder to refinance in the capital markets and will likely have to rely on banks.
Oil and gas	As many end users refuse to buy Russian oil in what is essentially a de facto ban adding to concerns that there will be further bans on Russian crude outside those from the U.S. and the U.K., the extreme volatility in the oil and gas markets is unsurprising. The longer oil and gas prices remain elevated, the more political pressure North American producers will feel to ramp up production to meet demand. Most producers, while seeing higher labor and material costs, aren't too concerned about margin pressures given the level of hydrocarbon prices. Oilfield-services companies, which still aren't quite experiencing the full impact of high hydrocarbon prices due to measured capital expenditures from producers, have for the most part been able to pass through higher material costs. However, given pockets of labor shortages, they haven't been able to meet some demand, and it remains to be seen just how quickly they can add staff and pass along what are sure to be higher labor costs.
Oil refineries	We believe refining margins in most regions will improve as demand recovers and outpaces supply and utilization runs that will likely remain below pre-pandemic levels. The U.S. market is set to rebound with stronger demand and higher margins and lower renewable identification number (RIN) prices. We expect refiners to chip away at higher debt burdens, which they used to bolster liquidity when demand fell in 2020-2021. We also believe shareholders could benefit from a return of capital if balance sheets strengthen. Latin America will likely see mixed results due to more systemic operating challenges and possible shifts in political views. China continues to manage domestic capacity, closing smaller refiners in favor of large, integrated refining and petrochemical complexes and a strong push to electrify the vehicle fleet. Given recent developments with the Russian invasion of the Ukraine, refining margins have expanded considerably, and most refining companies believe that these stronger-than-anticipated margins could hold at least through the second quarter. However, they caution that the second half is more uncertain, particularly around the strength of demand if retail prices remain well above historical levels and inflation doesn't subside.
REITs	We are seeing more stabilization across the REIT sector, with expectations for good revenue growth and improvement in credit metrics. Most retail REITs have achieved pre-pandemic level rent collection and occupancy, and we expect solid growth this year, particularly for strip center REITs, while malls could still face pressure on rental growth. While we expect office utilization to increase, we still expect the office REITs to show slow recovery in leasing and rent/occupancy growth. Other property types, such as industrial and rental housing are showing solid growth in rent and occupancy due to robust demand. Negative bias eased to 15% of ratings with negative outlooks given recovery in credit metrics and normalization of operating trends. REITs are pursuing more aggressive growth with higher levels of acquisitions, which could delay recovery in credit metrics in some cases. High inflation could limit REITs' ability to raise rents, though most leases have built-in rent escalators tie to CPI or at fixed rate. Sustained rate hikes could have more negative impact on valuation, particularly lower quality assets or sectors facing secular headwinds such as retail and office.
Regulated utilities	The sector outlook has been negative since early 2020. Credit quality for the investor-owned North America regulated utility industry weakened in 2020-2021 with the median rating falling for the first time ever to the 'BBB' category. Given the relatively high percentage of the industry with a negative outlook (about 20%), the strategic management of financial measures with only minimal cushion from the downgrade threshold, the industry's high capital spending, ESG credit risks, inflation, rising interest rates, and higher commodity prices, we expect that it is more likely that downgrades will

	again outpace upgrades this year. Should this occur, it would be the first time in more than 30 years that downgrades outpaced upgrades for three consecutive years.
Retail and restaurants	Retail and restaurants are enjoying strong consumer demand. They haven't reported price elasticity to date. And restaurants are experiencing another uptick in demand as omicron fades. However, there is an expectation that at the lower end of the income spectrum, consumers are more sensitive. Inflation hasn't worked through the system entirely, so retailers face the prospect of growing price sensitivity as consumers see the writing on the wall in terms of inflation and risks from Russia-Ukraine. We believe emerging price sensitivity will start in the discount space and casual diners. At the same time, off-price and discounters will benefit from the trade-down from full-price retailers. Profitability is likely to come down as inflationary pressures intensify and consumers start balking at price increases. The sector had a 20% default rate in 2020, so we believe many issuers dealt with troubled balance sheets then and are well-positioned now.
Technology	The tech sector is likely to perform well, given IT spending is likely to grow faster than global GDP growth. Supply constraints remain the key issue for vendors to meet demand, leading to increasing backlogs. Still, this translates to decelerating growth rather than declines. Meanwhile, tech companies have been successful in passing along higher prices to customers, thereby maintaining profitability. The biggest concern is if the macroeconomic environment deteriorates significantly, then enterprise customers or consumers would be unwilling or unable to absorb higher costs currently being passed along by tech vendors. We believe any unmet demand is simply being pushed out rather than lost as the secular trends of cloud computing, digital transformation, 5G buildout, etc. are intact.
Telecom	We expect in-home broadband providers will continue to benefit from higher data consumption, although growth could moderate as more people return to the office. Shifting technology and consumer behavior will continue to result in rising data usage and continued cash-flow growth. We expect competition to increase in wireless as carriers try to differentiate their 5G capabilities as well as increased competition from cable. We think wireless service revenue growth will moderate this year due to slowing subscriber growth, partly offset by consumers migrating to higher-priced data plans as they upgrade to 5G. Among wireline companies, we expect cash flow and leverage metrics to weaken in the next couple of years as they invest in fiber to the home (FTTH). At the same time, they continue to lose broadband share to cable in the SMB and residential segments from the loss of copper-based broadband customers.
Transportation	The Russia-Ukraine conflict has pushed up oil prices, a particular concern for transportation companies. Airlines are highly exposed to higher oil prices. Few among rated U.S. airlines hedge fuel prices, while others rely on raising fares to offset higher fuel costs. Their ability to do so improved with consolidation of the U.S. airline industry but nonetheless is subject to how quickly and how high jet-fuel prices rise and the balance of supply and demand for airline seats. On the latter, U.S. airlines are relatively well-positioned, as they are entering a seasonal upturn in bookings, there is considerable pent-up demand for travel, and the recent rapid retreat of omicron infections and dropping of mask mandates (though not yet on planes). Supply is somewhat constrained by airline staff shortages and pilot-training requirements. This creates a situation in which airlines should be able to recoup much of the higher fuel expense without losing much traffic. Still, we expect airline earnings and cash flow, which took a hit from omicron in January and February, to recover more slowly than we once thought. A more immediate effect of the conflict and Western sanctions has been on global aircraft-leasing companies with loss of their aircraft on lease into Russia. In response to sanctions, Russia has seized leased Western aircraft to avoid their repossession. The proportion of aircraft value affected for rated lessors ranges from 2%-10%. Lessors carry insurance against an inability to repossess planes due to the actions of the airline or a country, but there may be large and protracted legal struggles between lessors and their insurance companies over this. Demand for freight transportation remains strong—although meeting it could be difficult given various supply constraints. In the meantime, pricing for trucking and equipment leasing is up substantially. Freight companies can generally raise prices to offset costlier fuel through surcharges or market rates, so less of an issue than for airlines.
Unregulated (merchant) power	From second half last year into 2022, power sales have held up and trend at levels seen in 2019. Only a severe recession is likely to hurt volumes. Also, power prices have risen because of the steep rise in the price of natural gas. Energy margins also appear to be rising, resulting in stronger spark spreads (gross margins). However, this has been offset by lower capacity prices. Overall, we expect weaker performance as higher margins in the wholesale power sector will be lost in retail sales for IPPs. Many IPPs had anyway hedged energy margins in the past two years won't benefit from higher current year spark spreads.

Appendix 2: Economic Data And Forecast Summaries

Table 6

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

	2021	2022f	2023f	2024f	2025f
Real GDP (year % ch.)	5.7	3.2	2.1	2.0	2.3
Real consumer spending (year % ch.)	7.9	3.3	2.2	2.4	2.5
Real equipment investment (year % ch.)	13.0	5.3	2.8	3.5	4.4
Real nonresidential structures investment (year % ch.)	(8.1)	(2.8)	5.9	4.2	3.9
Real residential investment (year % ch.)	9.1	(0.4)	0.1	1.2	1.4
Core CPI (year % ch.)	3.6	5.2	2.2	2.0	1.9
Unemployment rate (%)	5.4	3.6	3.5	3.5	3.5
Housing starts (annual total in mil.)	1.6	1.7	1.6	1.6	1.6
Federal Reserve's fed funds policy target rate range (year-end %)	0-0.25	1.75-2.00	2.75-3.00	2.50-2.75	-

Note: All percentages are annual averages, unless otherwise noted. 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 7

Canada – S&P Global Ratings Economic Outlook

	2021	2022f	2023f	2024f	2025f
Real GDP (year % ch.)	4.6	3.7	2.6	1.9	2.2
Household real final consumption (year % ch.)	5.1	5.6	3.6	2.3	2.3
Real equipment investment (year % ch.)	7.1	7.0	3.8	3.4	3.3
Real nonresidential structures investment (year % ch.)	(0.6)	2.1	3.8	3.4	3.3
Real residential investment (year % ch.)	15.4	(3.6)	(1.7)	0.6	3.6
Core CPI (year % ch.)	2.3	3.4	2.1	1.9	1.9
Unemployment rate (%)	7.4	6.4	6.4	6.2	6.1
Housing starts (annual total in thousand)	276.6	244.3	229.4	239.5	249.0
CAD/USD exchange rate (per US$1, period average)	1.25	1.28	1.31	1.27	1.22
Government of Canada 10-year bond yield (%)	1.4	2.2	2.6	2.8	2.9
Bank of Canada overnight rate (%, end of period)	0.25	1.25	1.75	2.00	2.00

Note: All "year % ch." are annual averages percent change. Core CPI is consumer price index excluding energy and food components. f—forecast. Sources: Statistics Canada, Oxford Economics, and S&P Global Economics' forecasts.

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