S&P Global
Ratings

Global Credit Conditions Q4 2022

Darkening Horizons

Sept. 29, 2022

This report does not constitute a rating action

Key Takeaways

- With global credit conditions at an inflection point, S&P Global Ratings expects credit fundamentals of rated corporations and sovereigns to erode amid slower economic activity, tighter financing conditions, and protracted inflationary pressures.
- Credit ratings have reached a post-COVID peak and started to deteriorate. We expect downgrades to pick up--particularly among issuers in the consumer goods, retail, and auto sectors--and overall defaults to double above 3% by mid-2023 from historically low levels currently.
- The balance of risks is firmly on the downside--with rapid monetary tightening potentially pushing major economies into recession; growing geopolitical tensions exacerbating Europe's energy crisis; lingering high prices pressuring costs and eroding households' purchasing power; and China grappling with structural factors that are undermining its economic growth.

Global Credit Conditions: Key Highlights

Global downturn
60%
of economies are slowing or facing mild recession

Disorderly inflation
450 bps
above central bank targets in 29 of the 33 countries covered

Monetary tightening
+90 bps
on average (Fed, BoE, ECB) before rates peak in 2023

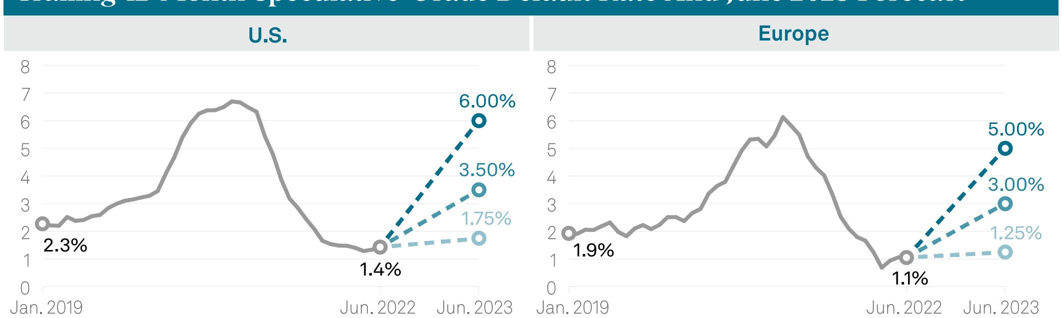
Negative outlook bias
12%
Sectors with highest bias:
19%: Consumer products
17%: Automotive
17%: Retail/restaurants

Gas prices
up 2.2x
since Jan. 2022

TTF: **+8.2x**
Henry Hub: **+3.2x**
versus last three years

Corporate debt
$1.1 tril.
rated 'B-' or lower and
81%
of EM corporate debt due in 2023 is in US$

Trailing-12-Month Speculative-Grade Default Rate And June 2023 Forecast



Trend lines point to our optimistic-, base-, and worse-case scenarios. Negative bias as of Sept. 23, 2022, calculated as the percentage of ratings with negative outlooks. Other chart data is as of Aug. 31, 2022. Sources: S&P Global Ratings Research and S&P Global Market Intelligence's CreditPro®.

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Global Credit Conditions

(Editor's Note: S&P Global Ratings' Credit Conditions Committees meet quarterly to review macroeconomic conditions in each of four regions: Asia-Pacific, Emerging Markets, Europe, and North America. Discussions center on identifying credit risks and their potential rating 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 Sept. 22, 2022.)

Macro Highlights

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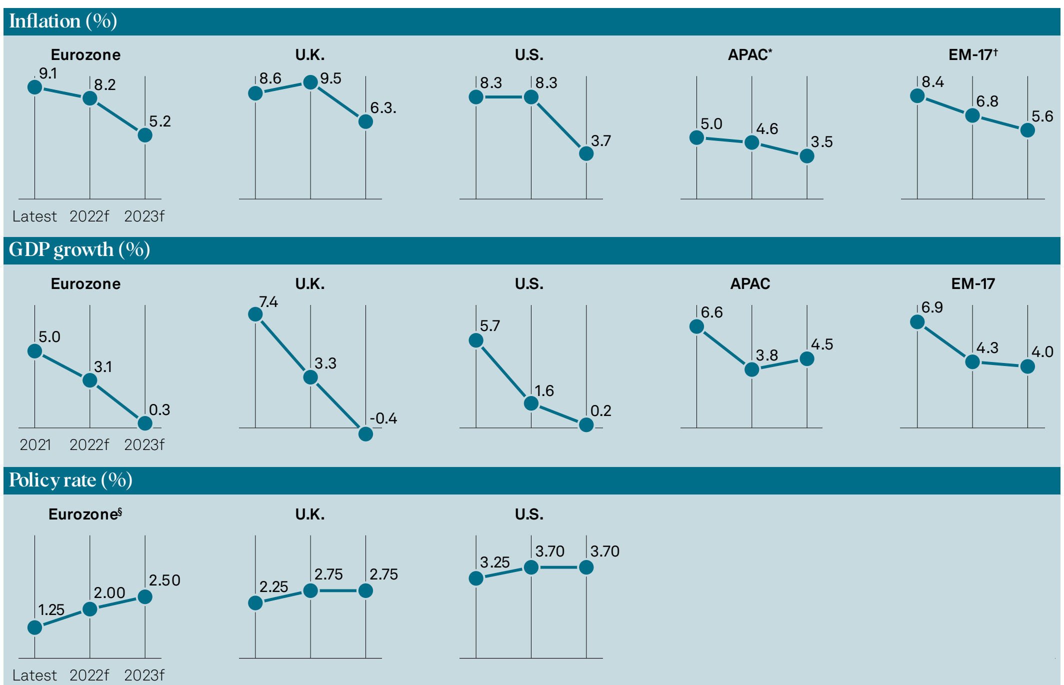
Several Routes To The Bottom

Growth is slowing almost everywhere, given that rising rates, Europe's intensifying energy challenges, and the lingering effects of the pandemic weigh on sentiment and activity. As central banks aggressively raise rates to fight inflation, our confidence is waning that they can avoid generating a sharp downturn. We already expect a mild recession in the U.S. and a sharp slowdown in the European economy--with Germany and Italy going into recession. The key variable to watch is labor market performance, which has so far remained robust thanks to historically low unemployment rates in the largest economies.

We have in general lowered our forecast for GDP growth in 2022 to 3.1% and in 2023 to 2.4% (from 3.3% and 3.5%, respectively), putting an end to the post-COVID rebound, and raised our forecast for inflation. The risks around this baseline remain on the downside.



Inflation data as of August 2022. Policy rates as of Sept. 26, 2022. *Simple average. †Median for EM 17 countries. §Refi rate.
Sources: S&P Global Ratings Economics.

Prospects for a near-term recovery are unclear. While the mild recession in the U.S. (as a result of classic overheating) should resolve fairly quickly, Europe’s energy reconfiguration will take years to complete, and its economic growth outlook will remain subdued because of the uncertainty stemming from the Ukraine-Russia military conflict. Moreover, the timing of China’s move away from its draconian zero-COVID policy is unpredictable, and many structural factors--including the real estate sector's woes and corporate debt overhang--will continue weighing on the country's growth prospects. Across emerging market economies (EMs), we expect a mixed picture: most EMs will take a hit from the slowing growth in China, the eurozone, and the U.S., and many will be vulnerable to currency depreciation and tighter financing conditions, which will raise inflationary pressures and financing costs, and restrict access to credit markets. Few EM energy exporters could benefit, because we expect oil and gas prices to remain high.

Global Credit Conditions

Pressures Are Intensifying As Global Economy Stumbles

Credit conditions are at an inflection point. The largest economies are facing looming recessions as the inertia from fiscal and monetary stimulus implemented to weather the pandemic's effects and the reopening economic boost that followed are unevenly replaced with the major global central banks' accelerated and substantial monetary tightening. We view these efforts to confront severe inflationary pressures as weighing on economic activity over the coming months. We expect inflationary pressures to be protracted and particularly driven by the Russia-Ukraine military conflict's implications for energy and food prices, which we expect to linger.

Over the coming months, persisting cost pressures and slower economic activity will erode corporations' buffers. During the pandemic, most corporations remained resilient thanks to government support (fiscal and monetary stimulus, along with loan deferral programs), cost containment, and debt refinancing. The post-pandemic economic boom enabled entities to pass on the increase in input cost to their end-customers and reap record-high earnings. Moreover, corporations were able to take advantage of abundant and cheap liquidity to lock in low costs of debt and extend their maturities.

Over the coming months, we expect corporations to grapple with rising costs and tighter financing conditions amid more restrictive monetary policy and slower economic activity as households' purchasing power erodes and consumer confidence wanes. As a result, we expect the pace of downgrades to pick up--particularly in sectors such as utilities, consumer goods, auto, retail, restaurants, and media and entertainment--and defaults to double above 3% by mid-2023. Worsening credit conditions will reflect margin erosion and, among lower-rated issuers, the inability to refinance debt or deal with increasing financing costs.

We expect widening pressures for sovereigns in dealing with rising food and energy prices, along with increasing financing costs. Such conditions will be tough for sovereigns, considering their weaker fiscal flexibility after the pandemic. Most sovereigns have enjoyed extraordinary tax collections thanks to inflation and supportive economic activity in the first half of the year. However, slower economic activity will further pressure sovereigns' fiscal balance in the next two years. Therefore, we don't expect government measures to parallel those during the pandemic, and the objective will likely be more focused on aiding households. While each government faces different challenges, they overall have less fiscal room to address new challenges as the pandemic significantly eroded sovereigns' fiscal accounts. Most major economies are dealing with high inflation, and in response, are aggressively tightening their policy rates, taking monetary stimulus off the menu. At the same time, rising energy and food inflation is forcing governments to deliver hefty fiscal programs to contain rising prices, prioritizing social stability over fiscal consolidation, while the latter is much needed.

The balance of risks is firmly on the downside. The potential for a prolonged period of high prices and low economic growth is rising. Many factors could heap more pressure on the already waning economic prospects. The U.S. economy faces a potentially hard landing if the Federal Reserve's ongoing efforts to curb inflation fail; monetary tightening beyond current expectations could lead to a deeper-than-expected recession. Moreover, higher rates will further strengthen the U.S. dollar, aggravating inflationary pressures for commodity importers and capital outflows from EMs. In Europe, the spillovers of the Russia-Ukraine military conflict could lead to a severe energy crisis if compounded by a cold winter and failure to replace gas supplies to replenish reserves in 2023 and beyond. At the same time, the impact may be more substantial if energy price caps weigh on fiscal positions and, along with higher borrowing costs, lead to a widening of spreads of more exposed sovereigns (fragmentation). China's COVID lockdowns and the real-estate sector's meltdown have undermined the economic growth momentum, denting business activity, household confidence, and employment. Even if the COVID policy is lifted (possibly in 2023), China will be emerging into a much less conducive global environment--both economically and geopolitically.

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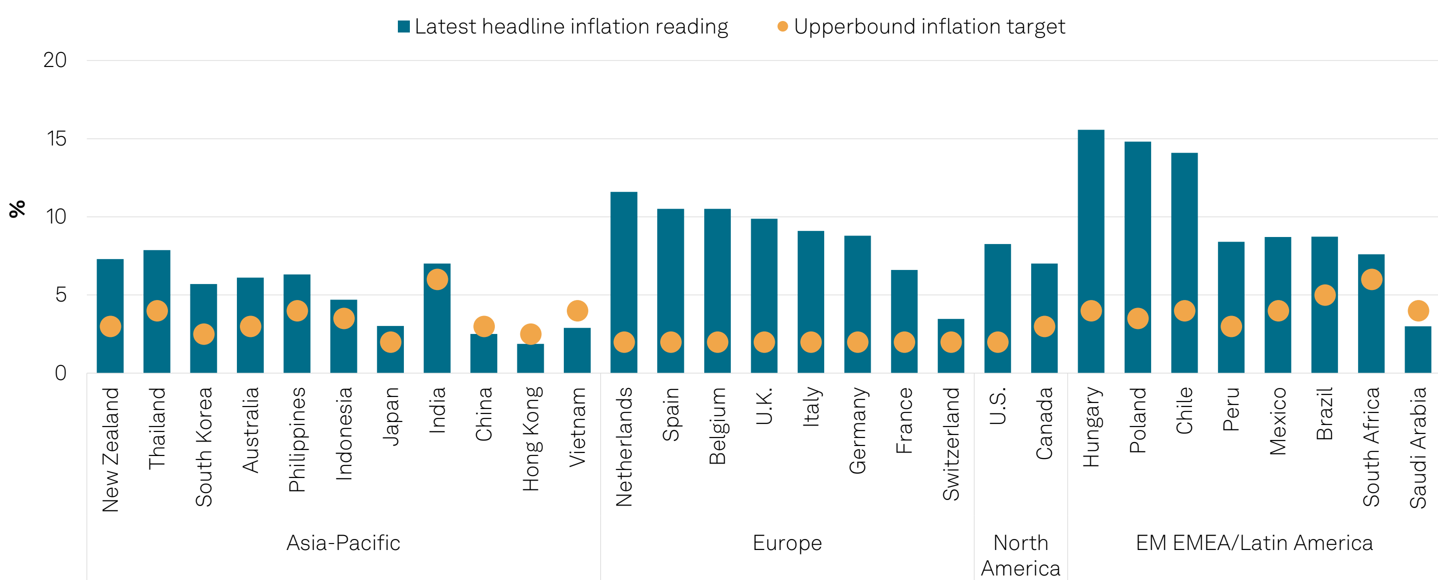
"The balance of risks is firmly on the downside--with rapid monetary tightening potentially pushing major economies into recession"

Geopolitical risks, which have heightened to levels not seen in decades, are threatening globalization. Russia appears to be set on an escalation of its military conflict with Ukraine and the economic one with the West, though key Russian allies--China and India--may yet intervene. While our base-case scenario excludes direct NATO military engagement in the conflict, the risk is not insignificant particularly if Russia decides to use unconventional weapons or causes Article 5 to be invoked. The conflict illustrates a deeper geopolitical schism between the autocratic and democratic blocs that could undermine decades of economic cooperation and development, with widespread implications for global security, trade, supply chains, communications, the environment, and global health. China has recently become the largest purchaser of Russian energy exports. Asian governments, seeking to dampen energy cost inflation, are also considering purchasing Russian oil and gas at a discount. Meanwhile, strategic confrontations between China and the U.S. and regional neighbours continue to flare up. Tensions have increased the likelihood of China moving down the decoupling route, which could disrupt supply chains, financial flows, and cross-border investments, threatening a substantial economic cost for the world.

Physical climate risks are heightening, extreme weather events are becoming more frequent, and the future of the energy transition appears uncertain. This year has seen particularly harsh droughts afflicting several regions, including the U.S., China, and Europe, while the amount and severity of fires around the world have reached historic highs. Severe floods have also caused significant damage in many countries, most recently in Pakistan. These extreme weather events can lead to high human and material losses, as well as increase the likelihood of potential shortages in food supplies and cause supply-chain disruptions. At the same time, the Russia-Ukraine military conflict has forced policymakers to prioritize energy security and affordability over sustainability in the short term. To protect energy supplies for businesses and households, Europe has delayed imminently phasing out some carbon-intensive energy sources, but has allocated more funds to renewable energy investments. Other countries are also refiring carbon-intensive fossil fuel energy sources to replace the more costlier energy alternatives The need for drastic policy actions in the coming years to achieve decarbonization objectives -- if they're put in place--could disrupt industries, with potential implications for business and financial risks in energy-intensive sectors.

Chart 1

Inflation is running above the upper bound of central banks' target in most economies



Data as of Aug. 31, 2022, Q2 for Australia & New Zealand, July 31 for Hong Kong and Canada. Source: Respective country monetary authorities.

Top Global Risks

A Sharper Slowdown In The Largest Economies Leads To A Global Recession

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

There's a growing risk that sharply rising interest rates, combined with a pullback by consumers, and Europe's energy crisis, will push the U.S. and Europe's largest economies into a deeper-than-expected recession, and cause a steep rise in unemployment. In China, the economic losses among the corporate and household sectors in 2022 could undermine a rebound of activity in 2023. With real estate accounting for nearly one-third of the country's GDP, prolonged weakness will depress economic growth going forward. Even if the zero-COVID policy is lifted (possibly in 2023), China will be emerging into a much less conducive global environment (both economically and geopolitically). A sharper-than-expected slowdown in China, the eurozone, and the U.S. could lead to a global recession.

Corporations Face Rising Margin Pressures Due To Persistently High Input Costs And Weaker Demand

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

Despite accelerating monetary tightening, inflation has yet to abate. Nevertheless, economic activity is already slowing down, and downside risks are rising, which could lead to a sharp recession. Furthermore, some of the factors pressuring prices haven't gone away, increasing the possibility of a slower economic activity with lingering high prices. In other words, the risk of stagflation is rising. As consumers' purchasing power erodes and pent-up demand after the pandemic fades, borrowers in many corporate sectors will inevitably find it harder to pass through costs. Margin pressures will amplify and weigh on credit quality in certain industries--particularly in countries going into recession.

Frontloading Monetary Tightening Leads To Overly Restrictive Financing Conditions

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

Central banks, including the Federal Reserve, Bank of England, and European Central Bank (ECB), will have to tighten monetary policy further before inflationary pressure wanes, and we expect financing conditions to become more restrictive. If central banks decide to accelerate quantitative tightening, by reducing their balance sheet positions on top of rising policy rates, financing conditions could rapidly become overly restrictive. As funding liquidity contracts and financing costs increase, lower-rated borrowers increasingly struggle to refinance and become more prone to default. Also, this scenario presents risks for EMs with heavy reliance on foreign funding, large external and/or fiscal imbalances, and exposure to a potentially further strengthening of the U.S. dollar.

The Russia-Ukraine Conflict Exacerbates Global Risks, Simmering China-U.S. Tensions Loom

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

The Russia-Ukraine military conflict has reached a stalemate, with heightened risk for escalation. Russia has weaponized its energy deliveries to Europe by cutting gas flows to the Nord Stream 1 pipeline. While Europe is close to replenishing its gas reserves for the winter, there's an increasing risk that it might struggle to do so in 2023 and 2024, and will continue facing extremely high gas prices over the coming years. Further cuts through other pipelines or a cold winter could aggravate risks for European entities and tip the region into a deep recession. The conflict could also keep energy and food prices persistently high. Tensions between China and U.S. continue to simmer. The Russia-Ukraine military conflict has placed China's relationship with Russia in focus and could exacerbate the likelihood of China accelerating its decoupling initiatives (reducing imports or de-dollarizing its financial system). Heightened global tensions among major countries could reignite supply chain mitigation strategies, spark restrictions regarding access to intellectual property, depress investor confidence, and diminish global cooperation regarding environmental and health priorities.

Structural Risks

Physical Risks From Climate Change Weigh On Growth And Food Supplies, While Decarbonization Goals Suffer A Setback Amid Energy Security Concerns

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

The Russia-Ukraine military conflict has forced policymakers to prioritize energy security and affordability over sustainability in the short term. To protect energy supply to businesses and households, some of the short-term phaseout of carbon-intensive energy sources has been delayed in Europe, but investments in renewable energy are ramping up. Other countries are also refiring carbon-intensive energy sources to replace the more costlier energy alternatives. This delay will potentially widen the gap between global greenhouse-gas emissions and actions required to limit 1.5-degree Celsius rise, making it harder for policymakers to balance short-term social and economic priorities with long-term decarbonization ambitions. Different countries are exposed in different ways to the environmental challenges, whether through physical risk, adaptation costs, or overhauling the fossil-fuel exporting industries. The need for drastic policy actions in the coming years--if they're put in place--could disrupt industries, with potential implications for business and financial risks in energy-intensive sectors.

Cyber Attacks Disrupt Business Models And Increase Systemic Risks

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

Amid increasing technological dependency and global interconnectedness, cyber attacks pose a potential systemic threat and significant single-entity event risk, with the Russia-Ukraine military conflict raising the prospect of major attacks. Criminal and state-sponsored cyber attacks are likely to increase, and with hackers becoming more sophisticated, new targets and methods are emerging. As public and private organizations accelerate their digitalization, a key to resilience is a robust cybersecurity system, from internal governance to IT software. Entities lacking well-tested playbooks (such as active detection or swift remediation) are the most vulnerable.

Sources: S&P Global Ratings.

Risk levels may be classified as, moderate, elevated, high, or very high, and are evaluated by considering both the likelihood and systemic impact of such an event occurring over the next one to two years. Typically, these risks are not factored into our base-case rating assumptions unless the risk level is very high.

Risk trend reflects our current view on whether the risk level could increase or decrease over the next 12 months.

Global Credit Quality Reaches A Post-COVID Peak

- Momentum in global credit quality has reached its post-COVID peak.
- Persistent headwinds from inflation, increasing rates, geopolitical tensions, and rising recession odds have started to cause credit quality to deteriorate. Furthermore, we expect defaults to double in our base-case scenario and spike to 5%-6% in a worse-case scenario.
- Though increasing credit stress is expected, this is coming after a protracted period of a subdued pace of downgrades, historically low negative bias, and minimal defaults.

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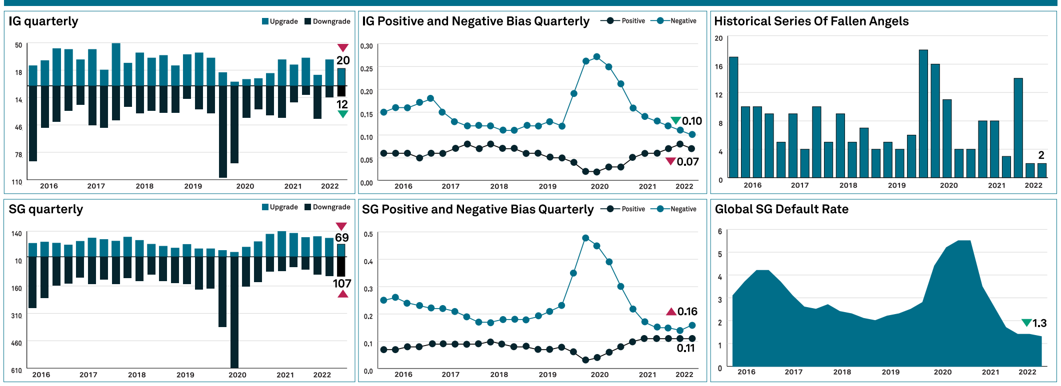
Changes ● Positive ● Negative ● No The arrows indicate week over week trend

Rating and outlook trends



Ratings at a glance

	North America	Europe	Asia Pacific	Emerging markets
Net outlook bias	(4.8%) ▼	(3.8%) ▼	(0.6%) ▲	(3.8%) ▲
Potential fallen angels	2.5% ▲	2.2% ▼	2.4% ▲	4.7% ▲
Weakest links	10.3% ▲	8.0% ▼	9.2% ▼	9.5% ▲

Regional default insights

	North America	Europe	Asia Pacific	Emerging markets
Q3 tally	9 ▼	5	3 ▼	4 ▼
2022 tally*	26	10	15	20
2021 tally*	33	13	6	12
Leading sector*	Consumer products	Media and entertainment	Homebuilders and real estate	Homebuilders and real estate

Weakest links are defined as issuers rated 'B-' and below, with either a negative outlook or on CreditWatch negative. Weakest links are shown as percentage of speculative-grade population. Regions include North America (U.S. and Canada), Europe, Asia-Pacific, and EMs (countries in Asia-Pacific, Latin America, and Europe). Data as of Sept. 23, 2022. *Captures year-to-date regional default tallies. Direction of arrow indicates quarter over quarter change. IG--investment grade. SC--speculative grade. North America includes the U.S. and Canada. Emerging Markets includes Asia-Pacific, Latin America, and emerging Europe defaults. Default counts may include confidentially-rated issuers. Net outlook bias refers to the percentage of issuers with a positive bias minus the percentage of issuers with a negative bias. All outlook bias calculations include global financial, nonfinancial and sovereign issuers. Sources: S&P Global Ratings Research and S&P Global Market Intelligence's CreditPro®.

Since the start of 2021, the momentum in credit quality has been very positive. Upgrades have consistently outpaced downgrades, and the speculative-grade corporate negative bias hit a multi-year low of 14% in the second quarter of this year. Default rates have remained well below 2% across developed markets for roughly six months or more, though they have been more elevated--but also declining--among EMs.

But credit quality is starting to take a negative turn. In August and September, the number of corporate downgrades has surpassed that of upgrades, and the negative bias among speculative-grade firms has risen through September 21. Moreover, defaults have picked up in recent weeks from the relatively benign pace in the U.S. and Europe. And though the negative rating momentum is currently small and starting from some of the most favorable points in recent years (few defaults, few fallen angels, low negative bias), the level of aggregate credit quality has remained weaker than in any prior period after the large rates of downgrades in 2020. The proportion of global issuers rated 'B-' and lower is currently 29%, slightly lower than the peak of 33% at the end of 2020, but consistent with the start of its ascent at the pandemic's beginning in March 2020.

"Momentum in global credit quality has reached its post-COVID peak."

We expect the deepest declines in credit quality in Europe, where roughly 21% of speculative-grade issuers have a negative bias, compared with about 16% globally, as of September 20. The ongoing conflict and the potential impact of severely high energy prices during the upcoming winter, combined with sharply higher interest rates globally, could accelerate the pace of downgrades. The Asia-Pacific region follows, with about 18% of speculative-grade issuers with a negative bias, mostly in the homebuilders/real estate sector. Sustained difficulties in the Chinese homebuilder sector has already led to a pick-up in defaults in the region, and we expect more downgrades and defaults, as stress in the property sector is likely to linger. Other sectors facing the greater downgrade potential are those subject to consumer spending declines, such as consumer products and retailers, as well as sectors vulnerable to higher supply-chain constraints and energy costs: automotive, transportation, metals, mining, and steel.

The tally of defaults has remained very low since 2021, particularly in the U.S. and Europe. However, our current default forecasts of 3.5% and 3.0% for the two regions, respectively, reflect strains taking their toll by mid-2023, as higher input prices, declines in consumer spending, and rising interest rates are likely to erode profit margins. In the U.S. and Europe, nearly half of 'CCC/C' issuers is in the three sectors heavily reliant on consumer spending: media and entertainment, consumer products, and retail/restaurants. Consumption has been resilient to date; however, if recent data readings such as steeply rising inflation expectations and plunging consumer sentiment surveys translate into similar movement in the hard data on actual inflation and consumer spending, these weaker sectors will lead the charge in defaults ahead.

If a longer, deeper recession were to take hold, our pessimistic default forecasts of 6% in the U.S. and 5% in Europe would become more likely. This scenario may include persistent inflation, which could be met with a greater pace of interest-rate hikes, at a time when even higher input costs and deeper contractions in consumer spending would be more likely. The growing odds of an energy price shock in Europe is a particularly acute point of pressure there.

Across Asia-Pacific and EMs generally, defaults have also started to appear in consumer-facing sectors, but the Chinese homebuilders sector has seen the highest number of defaults. Given woes in this country's housing market, we expect the sector to experience more defaults as well.

Global Financing Conditions: The End Of Cheap Money

- After a short-lived reprieve during the summer, interest rates have continued their upward climb, and there seems to be no reason to assume this rise will stop anytime soon.
- Rapidly rising rates continue to dampen debt issuance across most sectors this year, but rising benchmark rates are also keeping bond spreads relatively low.
- A swiftly rising dollar could put an additional pressure on EM debt - with roughly 85% of speculative-grade corporate EM debt denominated in U.S. dollars.
- Until inflation comes under control, the Federal Reserve and other central banks will continue raising rates, which will spill over into the financial system and make future debt much more costly.

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This year, financing conditions have tightened consistently and considerably. Interest rates have fallen through most of the summer, but as inflation has remained stubbornly higher than expected in the U.S., the Federal Reserve would continue to hike rates aggressively, which has also prompted expectations for continuation in raising rates further. Except for Japan, sovereign interest rates have been rising largely in lockstep around the world (see chart 1).

Currently, our economists expect the federal funds rate to reach 400-425 basis points (bps) by early 2023, while market expectations are currently even slightly higher. We expect the ECB to raise the terminal deposit rate to 2% by the first quarter of 2023. With these increases still looming, general interest rates are likely to continue to rise for the foreseeable future.

Despite rising rates, the promise of more hikes, a continuing Russia-Ukraine conflict, and growing odds of a hard landing in the U.S., relative risk pricing has increased at a relatively benign pace this year (chart 2). In fact, our U.S. speculative-grade spread has only increased to 440 bps, a historically modest level. In emerging Asia, spreads have barely budged, rising only 15 bps. Unsurprisingly, high-yield spreads have risen the most in Europe, showing a visible increase over U.S. spreads that began in February at the beginning of the conflict, but while still tracking fluctuations with their U.S. equivalent throughout the year.

Debt issuance in 2022 has fallen below 2021 levels across nearly every asset class and region, with the steepest drop-offs seen in high-yield bond markets (down roughly 75%). For the most part, declines in nonfinancial issuances have been consistent from the start of the year, and not particularly sensitive to any specific events. Globally, nonfinancial bond issuance has been down about 35% for most of this year. As the year has progressed, high-yield issuance has inched towards a wider shortfall month by month. And even leveraged loans have plummeted--roughly 70% in Europe and 40% in the U.S.--despite what should be a more appealing environment for them, given rising rates. The relative decline in loan volumes could reflect two factors: difficult comparisons with 2021, but perhaps also the persistent fear among investors of economic troubles ahead, which could challenge these typically much lower-rated issuers (largely within the 'B' category).

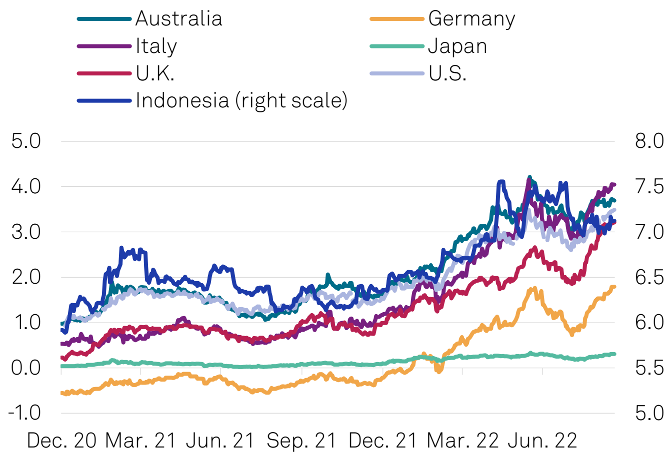
In addition to frigid primary markets, depreciating currencies could present an additional headwind for entities in EMs that have issued debt in dollars but their revenues are in domestic currencies (chart 3). This could be particularly acute for the speculative-grade EM issuers. So far, their bond issuance in 2022 has been a paltry $5.4 billion, an 87% plunge from the full-year 2021 level (chart 4). And since 2017, 92% of speculative-grade bond issuance has been in dollars.

Ultimately, despite multiple cross-regional strains, the Federal Reserve has been the primary driver of financing conditions this year. Unless other central banks raise rates to match those in the U.S., falling currencies will produce an additional drag for issuers amid rising global interest rates. And until inflation shows signs of abating, the upward trend of interest rates looks unlikely to stop.

Chart 2

Borrowing costs resume their upward rise

10-year government bond yields (%)

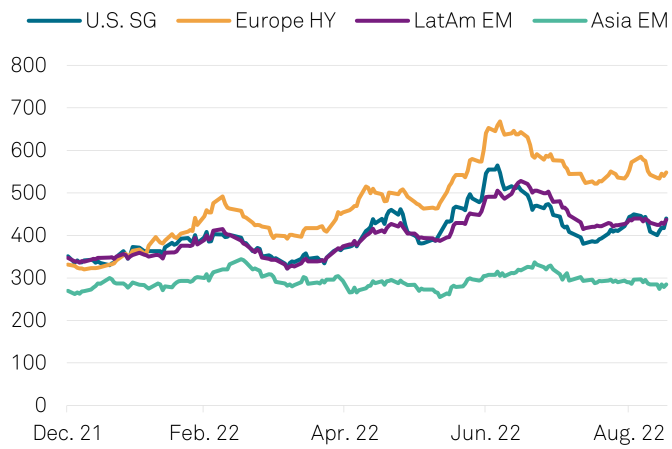


Source: S&P Global Market Intelligence, S&P Global Ratings.

Chart 3

Spreads mostly reflect modest risk levels, for now

ICE BofA option-adjusted spreads (bps)

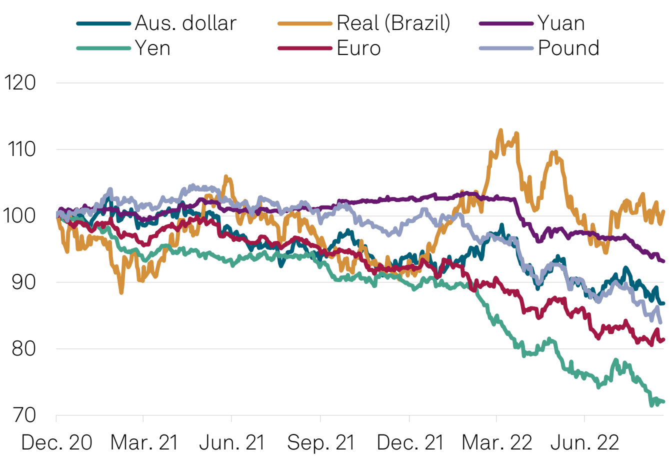


bps--Basis points. BofA--Bank of America. EM--Emerging market. HY--High yield. SG--Speculative grade. Source: S&P Global Ratings.

Chart 4

Foreign currencies fall quickly against the U.S. dollar

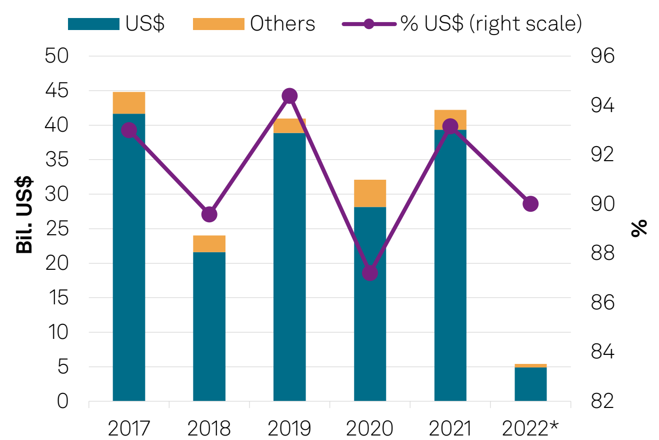
Dec. 31, 2020=100



Normalized for comparison, all currencies reflect their value relative to the U.S. dollar. Sources: S&P Global Market Intelligence, S&P Global Ratings Research & Insights.

Chart 5

Speculative-grade EM bond issuance shows closed markets and dollar vulnerability



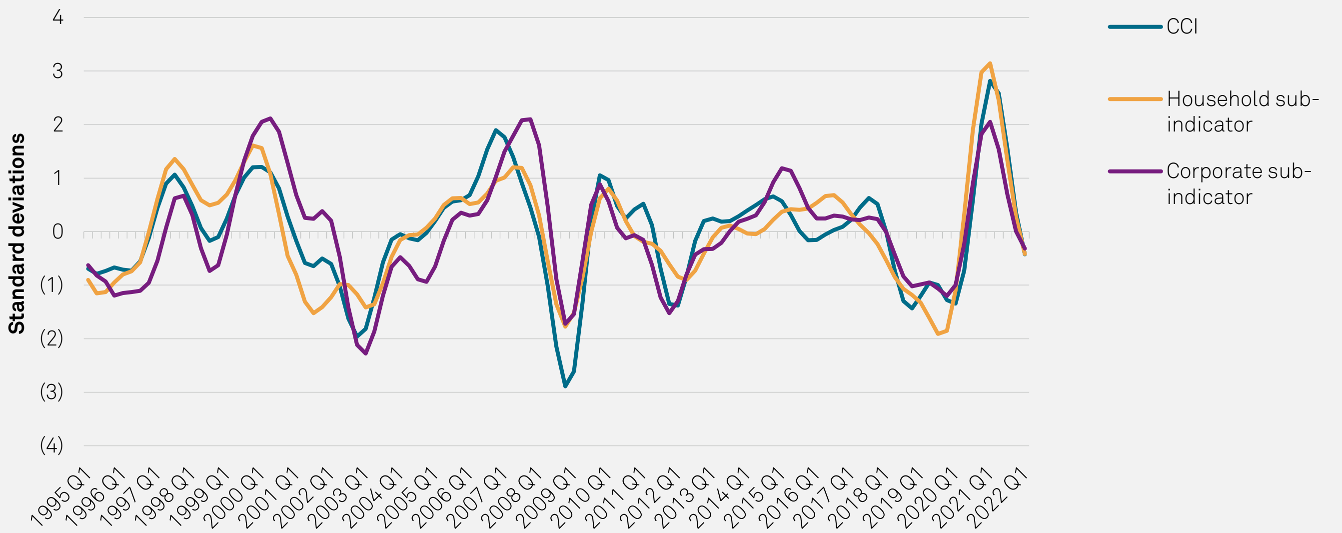
*Year-to-date as of Sept. 23, 2022. EM--Emerging market. Sources: Refinitiv, S&P Global Ratings Research & Insights.

Credit Cycle Signs Point To Heightened Credit Stress In Late 2022 Or Early 2023

During the four quarters since the first quarter in 2020, the Global Credit Cycle Indicator (CCI) trended upwards and reached a peak of 2.8 standard deviations in the first quarter of 2021. This suggests a potentially rise in credit stress in early 2023 (see chart 6). While the CCI is trending downwards--indicating a credit correction is underway--the potential impact of the buildup of nonperforming loans and defaults could linger beyond the stress period in late 2022 and early 2023. For more details about our proprietary CCI, see "White Paper: Introducing Our Credit Cycle Indicator," published on June 27, 2022.

Chart 6

Recent Peak In Global CCI Suggests Heightened Credit Stress In Late 2022 Or Early 2023



Peaks in the CCI tend to lead credit stresses by six to ten quarters. When the CCI's upward trend is prolonged or the CCI nears upper thresholds, the associated credit stress tends to be greater. Sovereign risk is not included as a formal part of the CCI. Sources: Bank for International Settlements, Bloomberg, and S&P Global Ratings. For detailed CCI trends read our Regional Credit Conditions Reports.

The Balance Of Risks Turns Negative For Sovereigns, Corporations, And Financial Institutions

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Sovereigns

While sovereign ratings have stabilized during 2022 amid the post-pandemic recovery, the outlook for the asset class is getting more difficult as we look further into 2023. The Russia-Ukraine conflict couldn't have come at a worse moment for the world. The global economy was starting to reopen and resume growth, triggering a massive spike in energy and food prices and overall inflation globally. Central banks are responding through a sharp monetary policy tightening that's making financing costlier, and for some sovereigns at the lower end of the ratings scale, not accessible--just when they needed it the most. Whereas in the first half of 2022, most governments' public finances have improved, mostly on the revenue side, due to the economic recovery and inflation, the pressures on consumers will grow in the second half of 2022 and in 2023 as economic activity will slow sharply, likely pushing several large economies into recession. This in turn will again put heavy pressures on policy makers to respond through fiscal policy that in the current context will be at odds with the monetary policy efforts to contain inflation. An indication of this dilemma is the U.K.'s recent announcement of fiscal support. Others will likely implement some version of strong fiscal support as well, as the energy crisis deepens, particularly in Europe and EMs that are net importers of energy and food. It's safe to say that these dynamics will be detrimental for most governments' balance sheets. The extent of the impact that this will have on sovereign ratings will depend on the position in which each sovereign is entering this new period of stress as well as policies each implements. So far during 2022, four sovereigns that we rate have defaulted (Belarus, Russia, Ukraine, and Sri Lanka). Currently, five sovereigns that we rate (Belarus, Lebanon, Sri Lanka, Suriname, and Zambia) remain in selective default. Looking forward, the risk of additional sovereign defaults is high. We currently rate eight sovereigns within the 'CCC' category, three of which have negative outlooks.

Table 1

Sovereign within the 'CCC' category

		Net GG debt / GDP (%)	CA balance / CAR (%)	GG interests / GG revenues (%)
CCC+	Argentina	70.3	2.9	5.3
	Burkina Faso	45.3	(16.2)	9.3
	Congo-Brazzaville	93.8	24.0	9.1
	El Salvador	75.3	(14.2)	17.9
	Ghana	81.3	(9.8)	45.1
	Mozambique	81.9	(48.7)	13.8
	Ukraine	103.2	3.5	12.8
CCC	Ethiopia	30.4	(35.7)	9.3

Blue: stable outlook.

Red: negative outlook.

Estimated data for 2022. Ratings as of Sept. 28, 2022. Source: S&P Global Ratings.

Corporations

Corporations across the globe will be grappling with the triple threat of lower demand, persistently higher costs, and greater risk aversion in the capital markets. The increasing negative downside risk in the macroeconomic scenario is reflected in the rating activity among corporations and utilities. In North America, the direction of rating changes has shifted to the downside in August, while the positive trend in Europe has been interrupted and the upgrades matched the downgrades in July and August. The sharp increases in raw material and energy costs are pressuring the companies' operating margins across many sectors, but many of them are still able to pass these increases to their customers. This is due to substantial order backlogs that haven't yet fully absorbed the spike due to COVID and the high employment that's supporting final customer demand. Still, as soon as inflation's full effect hits real disposable incomes, we expect demand to weaken. Consumers are already trading down, and this will be more evident in the next few months. This will be particularly the case in Europe, where the increase in natural gas prices is pushing the energy bills of companies and households to multiples of pre-pandemic levels. Without government support, the impact of higher energy costs--or the interruption of gas supply--will cause contraction of manufacturing and consumer spending in some European countries. Nonetheless, many corporations still benefit from two factors. The first one is the rating headroom stemming from solid results in 2021. Second, the limited financing needs in 2022 due to the heavy refinancing activity in 2020 and 2021 at extremely favorable terms. Both factors will likely be increasingly tested heading into next year, as margin pressures linger and monetary tightening continues to weigh on financing costs.

Chart 7

Global negative bias by sector (%)

Source: S&P Global Ratings.

Financial Institutions

Credit trends among financial institutions point to increasing divergence between banks and nonbank financial institutions (NBFIs). Key differentiating factors include funding and narrow business models of NBFIs. Tighter financing conditions have led to a funding squeeze for many of these entities, especially among speculative-grade ones, and resulted in several defaults among Mexican NBFIs. Conversely, most banks continue to benefit from ample deposit bases and strong liquidity buffers, even if issuance spreads have increased in line with market conditions. Asset quality will come under pressure, but from benign levels. Our base-case scenario assumes that the extent of asset quality weakening should be limited, thanks to resilient employment levels. Unlike trends in corporate sectors, the net interest income of many banks will likely continue to benefit from rising interest rates, partly compensating for the expected credit cost pressure. Overall, the net outlook bias for banks (see chart 9 was at 6% at the end of August 2022, up from a net negative 1% prior to the pandemic's outbreak in early 2020. But during the period, we downgraded 91 banks, compared with 47 upgrades. For NBFIs, the gap between downgrades and upgrades was slightly wider (103 versus 47 across a smaller range of rated issuers), while the net outlook bias was a negative 5% at the end August 2022.

Chart 8

Cumulative rating actions, Jan. 2020 – Aug. 2022

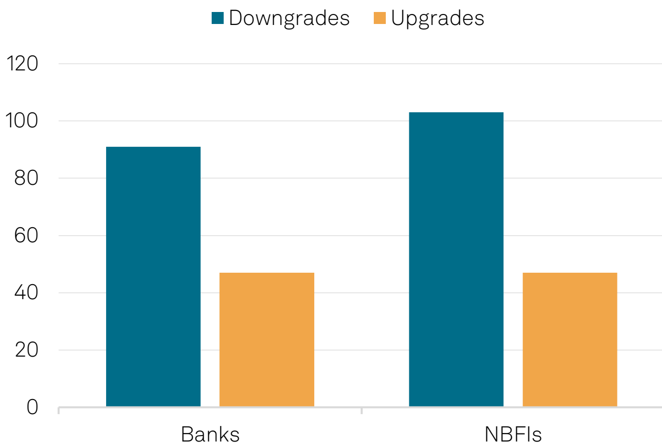
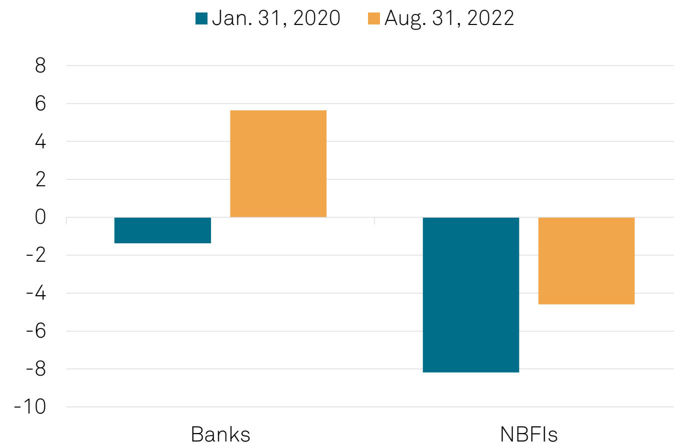


Chart 9

Net outlook bias (%)



NBFIs--Nonbank financial institutions. Source: S&P Global Ratings.

Economic Slowdown Will Test Credit Fundamentals

North America

Credit conditions for borrowers in North America remain strained, and could quickly deteriorate further amid the sharp rise in interest rates and the U.S. likely slipping into what could at best be a mild recession by early next year. The Federal Reserve has pledged to tighten monetary policy to whatever degree it must to rein in runaway inflation. This, combined with a pullback among U.S. consumers, could push the world's biggest economy into a deep downturn. Any worsening of economic momentum elsewhere (e.g., a further slowdown in China, contraction in Europe) could exacerbate the pain felt in the world's biggest economy.

Credit rating trends are turning negative. Downgrades have consistently outpaced upgrades since August, and the negative outlook bias began to increase in the third quarter after declining for almost two years. Defaults, too, look set to tick up, even with the headroom companies built up during the post-COVID recovery and the solid liquidity positions of most borrowers after highly favorable financing conditions in recent years allowed them to extend maturities. S&P Global Ratings now expects the U.S. trailing-12-month speculative-grade corporate default rate to rise to 3.5% by June 2023 from 1.4% in June 2022. While that's lower than the long-term average of 4.2%, the forecasted ratio would be more than double the current default rate. Much depends on the length, breadth, and depth of the recession.

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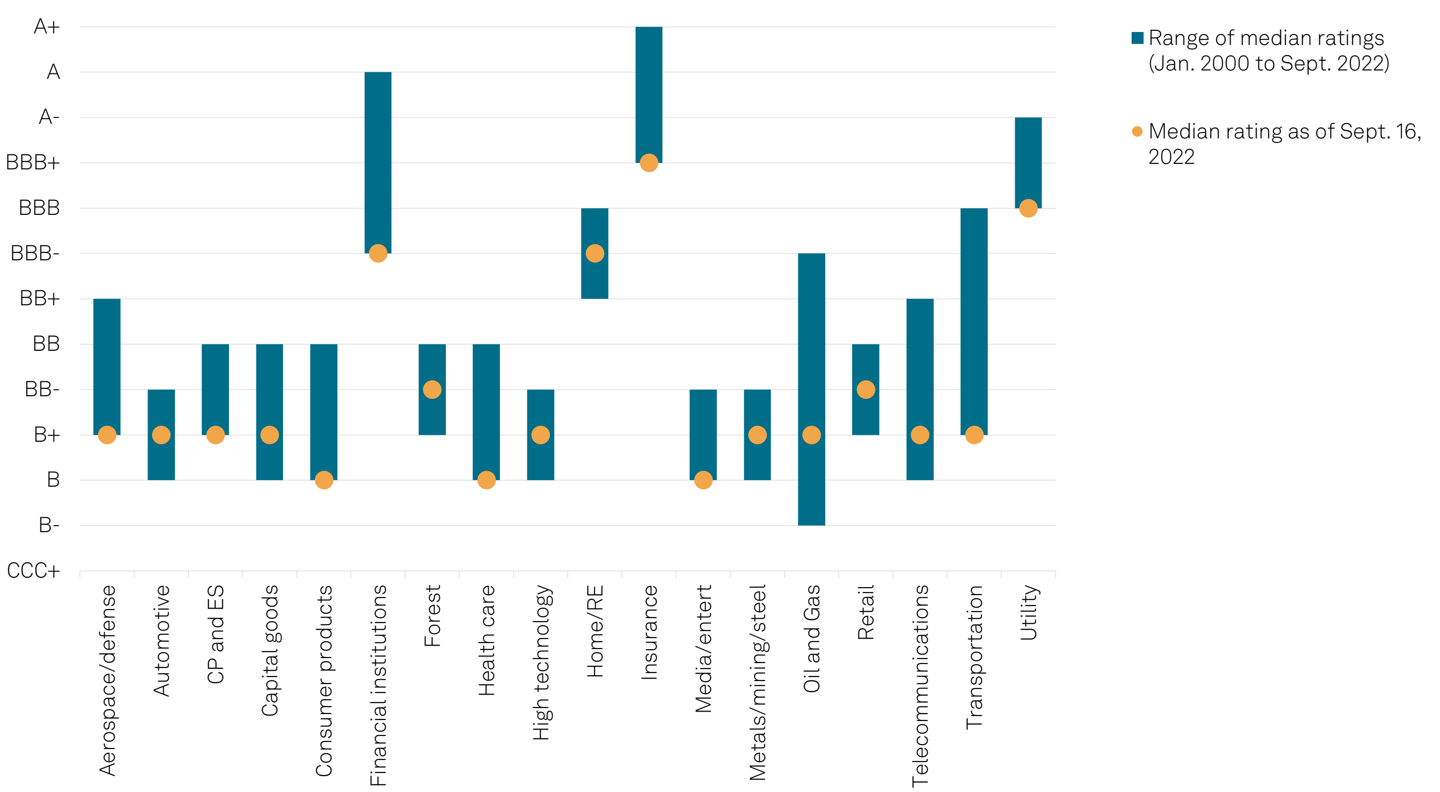
Chart 10

Nine sectors are at a historical low median rating



Source: S&P Global Ratings.

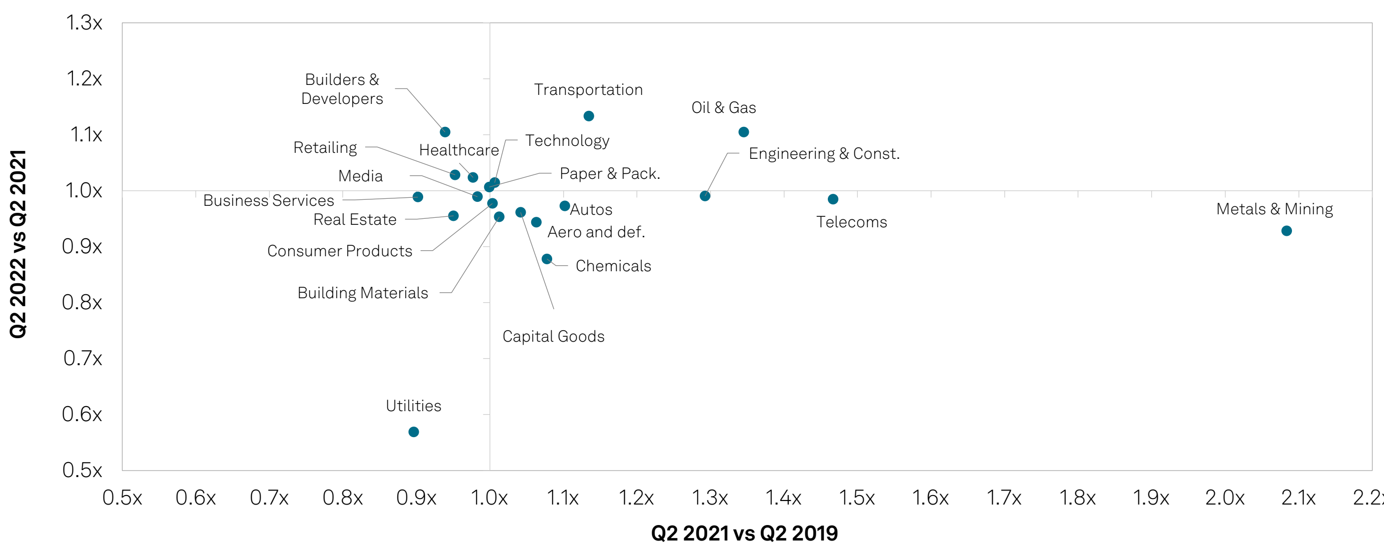
Europe

Credit conditions are set to become much more challenging over the winter, given that Russia appears to escalate its military conflict with Ukraine and the economic one with the West. This will likely keep gas and related power prices high for an extended period, fueling inflation that we expect to peak above 10%. Amid still tight labor markets, we expect this to lead to further substantial tightening in financing conditions, as the region's central banks rapidly adjust official rates to their neutral levels, and possibly higher. We now expect Europe to experience a mild recession, with economies in the U.K. and Germany contracting by 0.4% and 0.3%, respectively, in 2023. Risks remain very much on the downside.

As a result, recent resilience in ratings performance among non-financial corporations appears to have reached an inflexion point. Negative rating actions have occurred among utilities and in energy-intensive sectors such as chemicals, and we expect the same in the consumer discretionary sectors as inflation erodes consumers' purchasing power. Slowing growth in the U.S. and China is also weighing on export industries. A key signal is the weakness in corporate margins across many sectors after peaking in 2021, as it becomes harder to pass through cost increases in a slowing growth environment (see chart 11). Defaults are starting to tick up, albeit from historically low levels, and we expect them to reach 3% by mid-2023. Distressed exchanges are likely to become more frequent, given the back-up in yields and greater sensitivity of investors to underperforming credits.

Chart 11

Corporate sector margins coming under pressure in 2022 after record levels in 2021



Source: S&P Global Ratings.

Asia-Pacific

China’s COVID lockdowns and malaise in its real-estate sector have undermined the economic growth momentum. Credit conditions are set to worsen amid slower business activity, and weaker household confidence and employment. China’s mobility restrictions have hit consumption, taking a toll on the services sector and small- to mid-size enterprises. In our view, the Chinese government could start to ease its overall COVID stance after the first quarter of 2023, though it could be a very gradual pace.

Meanwhile, the real-estate sector's woes continue. Given continued mortgage boycotts, we believe delivering the unfinished homes by Chinese developers will be key to restoring market confidence. For the Chinese issuers, access to financing had narrowed, with offshore bond markets closed to high-yield issuers. This amplifies strains on Chinese property developers and local government financing vehicles, given their looming maturities. We could see more defaults occurring.

The severe drought has contracted hydropower generation and autumn grain output, which account for over 70% of the country's annual crop yield. The hydroelectric stoppages interrupted lithium and aluminum production, and depressed shipping activity. The disruption, coupled with COVID lockdowns, could exacerbate global supply-chain problems and fuel inflation, given China's dominant manufacturing role in the world.

Fears of a protracted recession in the U.S. and Europe, coupled with weaker growth momentum in China, are hurting business and consumer confidence. As a net exporter, Asia-Pacific is vulnerable to weaker global demand, hampering corporate revenue and profitability. The increasing fears of a global recession, and higher energy and food costs could force consumers to become more selective with discretionary spending. These conditions could make the pass-through of higher input costs to consumers more difficult.

Meanwhile, trends in the region's interest-rate policy are divergent, with China and Japan keeping rates low. Central banks in other countries of the region are hiking rates to rein in inflation and prevent capital outflows. Risk aversion among investors and lenders could compound currency weaknesses in the region (see chart 12). Costlier borrowing rates and more selective lending terms could exacerbate liquidity stresses for the region's corporations, narrowing rating headroom.

Chart 12

Asia-Pacific currencies pitch downwards

Percentage change in currencies, since June 2022 (%)

Data as of Sept. 20, 2022. Source: S&P Global Market Intelligence.

Emerging Markets

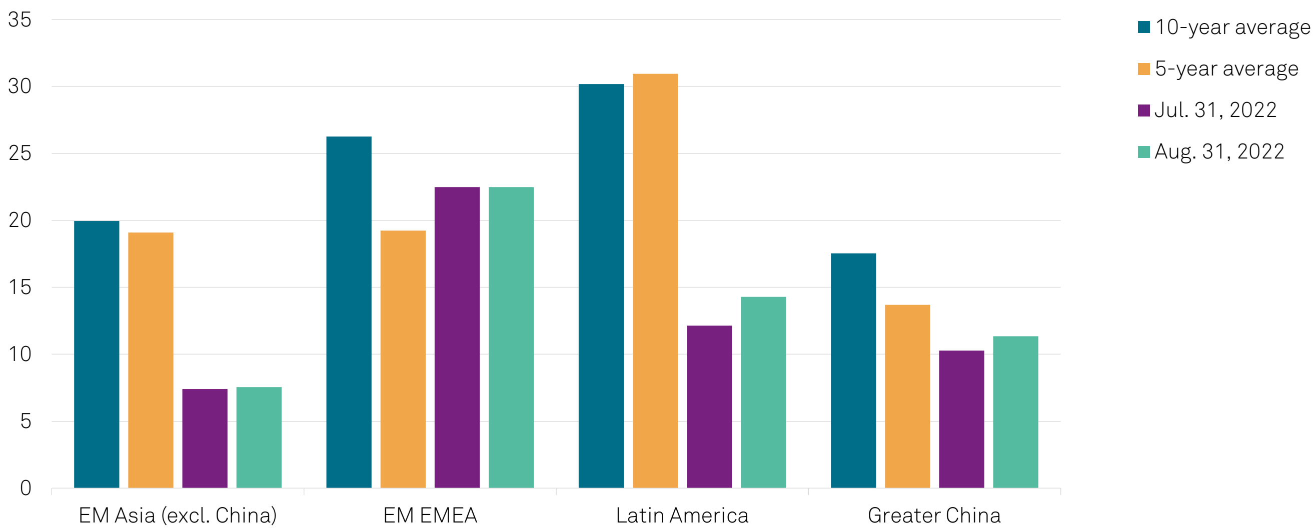
Our negative rating bias will probably widen across most EMs, as confluent risks erode issuers' credit quality. Around 60% of the world economy will either slow down or slip into recession in 2023. At the same time, inflation remains high and global liquidity is becoming scarcer and more expensive. We expect growth to continue decelerating for the majority of key EMs in 2023 (see chart 14). The pressure may increase for some EM sovereigns, given that higher commodity prices may prompt subsidies to increase, diminishing fiscal leeway. We also believe that the corporations' capacity to pass through higher costs to customers is weakening due to households' eroding purchasing power. If this continues, corporate margins could shrink further, households' credit quality weaken beyond our expectations, pressure on sovereign could increase, and banks' asset quality indicators would ultimately suffer. Finally, given the Federal Reserve's aggressive approach to taming inflation, there's a growing risk of interest rates staying high for a longer period, heightening market volatility and making overall financing conditions tougher for issuers across EMs. As local funding sources may prove scarcer and more expensive, the risk of default or distressed exchange of the weakest EM rated issuers will be on the rise.

EM Asia (excluding China) has the lowest downgrade potential, thanks to expected economic growth across most of the region. EMs in Europe, the Middle East, and Africa (EMEA) have the highest downgrade potential due to high external debt of some issuers and the vulnerability of others to changes in their operating environment. In Latin America, the negative bias remains noticeably below that in previous years, due mainly to two factors. First, our ratings reflect our assumption of continued economic recovery and falling unemployment for the remainder of 2022. Second, several downgrades occurred in the region over the past few years, so our ratings are generally much lower than in previous years, reflecting issuers' increased vulnerability.

Chart 13

EM EMEA has the highest downgrade potential

Regional negative outlook bias (%)



Data as of Aug. 31, 2022. Excludes sovereigns. EMs consist of Latin America: Argentina, Brazil, Chile, Colombia, Peru, and Mexico. EM Asia: India, Indonesia, Malaysia, Thailand, the Philippines, and Vietnam. EMEA: Poland, Saudi Arabia, South Africa, and Turkey. Greater China: China, Hong Kong, Macau, Taiwan, and Red Chip companies (issuers headquartered in Greater China but incorporated elsewhere). Source: S&P Global Ratings.

Appendix

Table 2

Updated GDP Forecast

Annual percentage change

	GDP growth rates							
	Forecast				Change			
	2022	2023	2024	2025	2022	2023	2024	2025
United States	1.6	0.2	1.6	1.9	-0.8	-1.3	-0.3	-0.2
Europe								
Eurozone	3.1	0.3	1.8	1.7	0.5	-1.6	-0.1	0.1
Germany	1.5	-0.3	1.2	1.3	-0.4	-2.3	-0.7	-0.3
France	2.4	0.2	1.8	1.5	-0.2	-1.5	0.2	0.0
Italy	3.4	-0.1	1.5	1.1	0.6	-2.0	0.0	0.3
Spain	4.5	1.1	2.1	2.6	0.4	-1.6	-0.4	0.4
U.K.	3.3	-0.4	1.4	1.6	0.1	-1.4	-0.3	-0.4
Asia-Pacific								
China	2.7	4.7	4.8	4.7	-0.6	-0.7	-0.1	0.0
Japan	1.6	1.4	1.4	1.3	-0.4	-0.6	0.3	0.3
India*	7.3	6.5	6.7	6.9	0.0	0.0	0.0	0.0
Emerging economies								
Mexico	2.1	0.8	2.0	2.1	0.4	-1.2	0.0	0.0
Brazil	2.5	0.6	2.0	2.1	1.3	-0.8	0.0	0.1
South Africa	2.0	1.6	1.7	1.7	-0.1	0.1	0.0	0.0
World†	3.1	2.4	3.2	3.3	-0.2	-1.1	-0.3	-0.1

*Fiscal year, beginning Apr. 1 in the reference calendar year. †World is in PPP terms, based on sample of 33 countries we cover (no longer includes Russia). Sources: S&P Global Ratings Economics, S&P Global Market Intelligence Economics and Country Risk.

Related Research

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