S&P Global
Ratings

U.S. Corporate Credit Outlook 2024

A Bumpy Ride To A Soft Landing

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This report does not constitute a rating action

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Key Takeaways

- While U.S. corporate earnings will likely improve modestly, we expect further credit deterioration, particularly at the lower end of the ratings scale. Borrowing costs look set to remain elevated and weigh on corporates' ability to service debt and refinance.
- Telecom, health care, chemicals, consumer products, and retail and restaurants have the highest net negative bias, suggesting a gloomier ratings outlook. The commercial office sector is also under intense pressure.
- The U.S. will likely avoid a near-term recession and settle into a "soft landing", but recession risks remain. Labor cost pressure and supply chain constraints could linger.

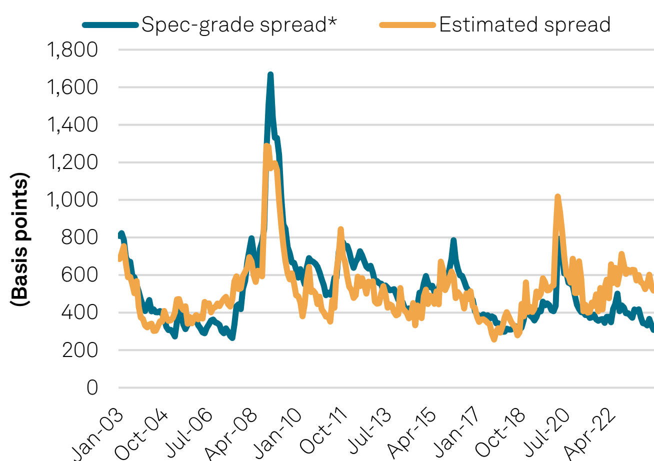
Credit stresses will likely continue for U.S. corporate borrowers in 2024, with persistent price pressures likely to keep interest rates elevated and investors becoming more cautious as GDP growth inevitably slows.

Interest rates remain a top concern (see table 1). Given ongoing labor constraints and supply-chain uncertainties re-emerging amid conflict in the Middle East and attacks on Red Sea shipping routes, inflation could remain hotter than the Federal Reserve would like. This complicates the job of policymakers, who could disappoint market participants betting that cuts to the federal funds rate will come sooner rather than later.

All-in borrowing costs will almost certainly remain elevated through the year, weighing on corporates' ability to service debt and refinance. After speculative-grade bond spreads narrowed to an average 308 basis points (bps) in December—the tightest in five years—they've since widened slightly. Still, we think markets remain overly optimistic relative to fundamentals. Our estimated average bond spread for December was more than 200 bps higher, as has been the case in recent years (see chart 1).

Chart 1

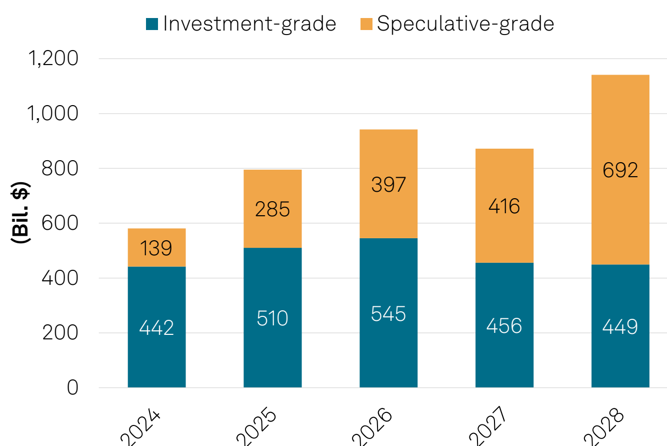
The estimated bond spread remains wider than actual



*Monthly average. Source: S&P Global Ratings.

Chart 2

Spec-grade corporate maturities rise through 2028



Data as of Jan. 1, 2024. Includes bonds, loans, and revolving credit facilities that are rated by S&P Global Ratings from U.S. nonfinancial issuers. Source: S&P Global Ratings.

Issuers have taken steps to address near-term maturities, trimming speculative-grade corporate debt due in 2024 by 44% over the past year. Regardless, speculative-grade debt coming due rises through 2028, and escalating maturities will add pressure to issuers' financing

needs in coming years (see chart 2). Lower-rated borrowers may feel more severe liquidity strains if financing conditions deteriorate further as maturities approach.

Recession risk persists. As corporate and consumer financial cushions erode, we could see more subdued business investment and/or a sharper slowdown in consumer spending—which could push the U.S. economy into recession, causing yet more credit stress. There are already signs that consumers are stretched, with American households (especially in the lower-income cohort) tapping more into their credit cards, with delinquencies on the rise.

Table 1

Key risks and opportunities around U.S./North American sectors' baseline

Sector	Risk/opportunity '1'	Risk/opportunity '2'	Risk/opportunity '3'
Autos	Geopolitical tensions	M&A in the suppliers space	Price war among OEMs
Building materials	Cost inflation	Refinancing risk	Sharper demand decline
Capital goods	Worse cyclical downturn	Higher interest rates	Energy transition
Chemicals	Lower demand	Tighter financing	Headwinds in Europe
Commercial aerospace	Supply chain constraints	Technical challenges	Aggressive financial policies
Consumer products	Robust labor market	Higher interest rates	Digitalization/cyberattacks
Defense	Defense spending declines	Supply chain constraints	Aggressive financial policies
Health care	Higher labor costs	M&A scrutiny	Legislative risk
Homebuilders	Cost inflation	More resale competition	Higher incentives
Leisure - gaming	Projects add leverage	Digital gaming	Tighter regulation
Leisure - hotels	M&A drives up leverage	Cost (wage) inflation	Macro weakness
Leisure - cruise, recreation	Cruise: deleverage	RV: macro weakness	Fitness: pullback in capex
Media - content	Smaller studios' profits	Higher cost of sports rights	Studio consolidation
Media - distribution	Streaming profitability	The Disney/Charter deal	Streamers' sports rights
Media - advertising	Macro weakness	Little forward visibility	Privacy/regulation changes
Merchant power	Excess cash on growth	Higher interest rates	Supply chain constraints
Metals and mining	Supply-demand imbalance	Project execution problems	Aggressive financial policies
Midstream energy	Macro weakness	Tighter financing	Climate change regulation
Oil and gas	Supply-demand imbalance	Policies; energy transition	Aggressive financial policies
Real estate	Refinancing risk	More credit metrics erosion	Rental/industrial assets
Regulated utilities	Climate change	Sales growth returns	Complex projects
Retail and restaurants	Consumer resilience	Reignited inflation	Tighter financing
Technology	Supply chain risks	Higher interest rates	Improving M&A activity
Telecommunications	Higher interest rates	More shareholder returns	FWA/FTTH competition
Transportation - airlines	Macro weakness	Geopolitical tensions	Decarbonization
Transportation - container shipping	Slower growth in trade	Sharper freight rates drop	Counterparty risks
Transportation - rail roads	Stalled service betterment	Regulatory/political risks	Macro weakness
Transportation - equipment leasing	Higher interest rates	Macro weakness	Supply chain constraints
Transportation infrastructure	Macro weakness	Geopolitical risks	Large capex
Most prevalent themes	Financing/interest rates	Macroeconomic conditions	Supply chain/cost inflation

FWA—Fixed wireless access. FTTH—Fiber to the home. Risks and opportunities have been simplified and standardized relative to the originals for cross-sectional clarity. No rank ordering is implied between the risks/opportunities. Source: S&P Global Ratings.

Elections and geopolitics are also in play. In addition to this year's U.S. presidential election, 33 Senate seats are at stake in regular elections, along with all 435 seats in the House of Representatives. S&P Global Ratings expects the ramifications for U.S. corporate borrowers will be predicated on the outcomes of both presidential and congressional elections—especially if there is a partisan split between the presidency and the upper or lower house (or both) of Congress, which would make passage of any sweeping legislation challenging and unlikely.

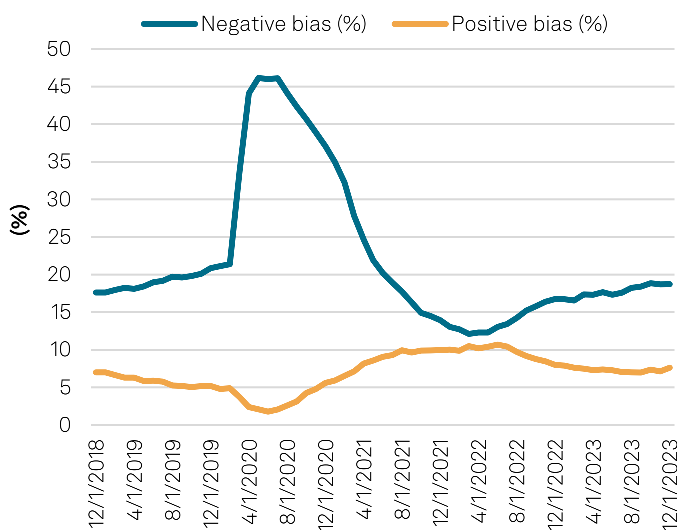
Elsewhere, attacks by Yemen-based Houthi rebels on shipping in the Red Sea are creating a bottleneck in a route that sees about 10% of global seaborne trade. This represents a worrying escalation of the Middle East conflict; the disruption has led to a tighter shipping market and a surge in freight rates. Still, we don't expect freight costs to reach the peaks during the height of the pandemic, when the demand premium consumers were willing to pay to obtain goods were exceptionally high. Spending on goods is now more balanced against services.

The tail risk is a severe energy supply shock, which could arise if Iran chooses to weaponize the energy market against the West by restricting transit through the Strait of Hormuz. But even barring an extended energy or food-supply shock, disrupted supply chains and the corresponding passthrough of higher costs could complicate central banks' efforts to control inflation and may require a recalibration of the pace of rate cuts that market participants expect.

We expect further credit deterioration, particularly at the lower end of the ratings scale. After 328 downgrades and just 205 upgrades in 2023, we expect this trend will continue this year. The net outlook bias for U.S. corporates started the year at negative 11% (see chart 3). Defaults have picked up and are poised to increase further as debt comes due and competition for funding intensifies. S&P Global Ratings Credit Research & Insights expects the U.S. trailing-12-month speculative-grade corporate default rate to reach 5% by September—above the 4.1% long-term average (see chart 4). If, as we expect, unemployment rises and discretionary spending declines, sectors reliant on discretionary spending will suffer most; borrowers in these sectors make up roughly half of those in the 'CCC/C' categories.

Chart 3

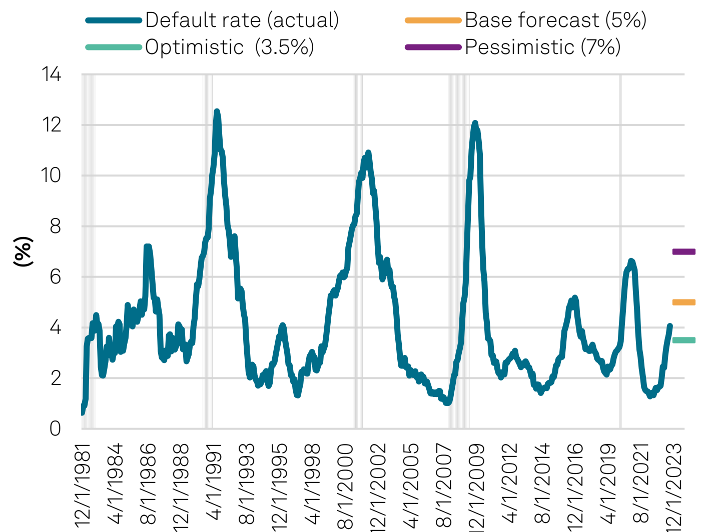
U.S. nonfinancial corporate outlook bias



Data as of Dec. 31, 2023. Negative bias—Percentage of issuers with a negative outlook or on CreditWatch negative. Positive bias—Percentage of issuers with a positive outlook or on CreditWatch positive. Source: S&P Global Ratings.

Chart 4

Defaults expected to continue rising through third quarter



Data as of Sept. 30, 2023. Gray bars represent the actual NBER-dated recessions. Sources: S&P Global Market Intelligence's CreditPro; S&P Global Ratings.

Macroeconomic Outlook

With inflation moving closer to the Fed's target and policy rates likely having peaked—while the U.S. labor market remains largely resilient—the world's biggest economy looks set to avoid a near-term recession and to settle into an elusive "soft landing."

Nonetheless, we expect below-trend GDP growth for this year and next, with unemployment drifting up to the mid-4% range by year-end. The imbalance between demand and supply in the labor market is narrowing, with private sector payrolls growth trending lower, quit rates falling back to pre-pandemic levels, and prime-age labor force participation improving. On the consumer side, we will likely see slower real income growth, a continued dwindling of household savings, and creeping affordability challenges. Some signs of consumers being stretched have emerged with American households (especially in the lower-income cohort) leaning more on their credit cards and delinquencies rising.

Inflation continues to slow, but the Fed has signaled that it will remain vigilant in its fight against price pressures, and borrowing costs remain relatively high. Still, with inflation closer to target and further disinflation in the cards, we believe policy rates have peaked and policymakers will begin to lower the federal funds rate in June.

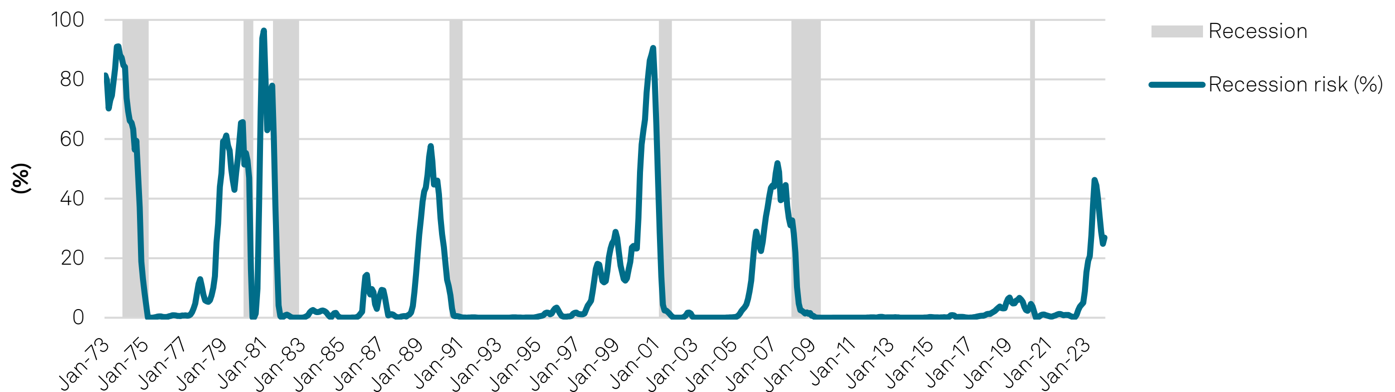
This doesn't mean borrowers can expect a return to rates near zero. We forecast three Fed cuts this year, which would bring the policy rate to 4.50%-4.75%. And we expect the yield on 10-year U.S. Treasury notes—a widely used pricing benchmark—to remain close to 4% through 2024. This means financing conditions will likely stay tight in real terms as "longer" becomes the operative word in the higher-for-longer environment.

More subdued business investment and/or a sharper pullback in consumer spending could lead to a recession and a jump in unemployment, causing more credit stress. We see the chance of recession in the U.S. in the next 12 months at an elevated 25%-30% (see chart 5).

Chart 5

The probability of a recession starting in the next 12 months is falling but remains elevated

Three-month moving average probability (%)



Data through December 2023. Gray bars represent the actual NBER-dated recessions. Sources: S&P Global Ratings Economics, Organization for Economic Co-operation and Development (OECD), the Federal Reserve, and St. Louis FRED. For more details, see U.S. Business Cycle Barometer: Recession Risk Moderates, But Growth Is Limited By Potential, Jan. 26, 2024.

Ratings Trends

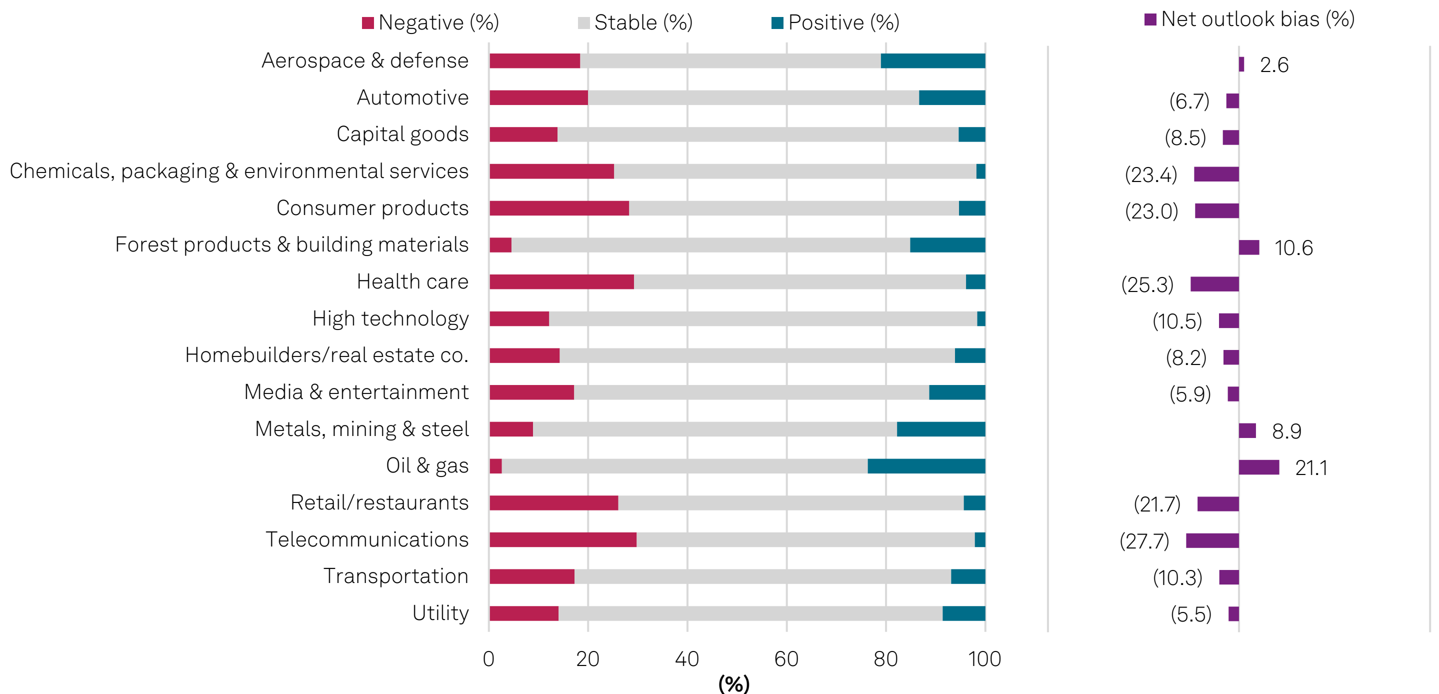
Telecom, health care, chemicals, consumer products, and retail and restaurants have the highest net negative bias, suggesting a gloomier ratings outlook (see chart 6). For U.S. telecom and cable operators, with about one-third of ratings having a negative outlook or on CreditWatch with negative implications, we expect downgrades will continue to outpace upgrades, as highly leveraged capital structures are increasingly stressed by elevated interest expenses, primarily among issuers in the lower end of the ratings scale. In health care, the credit deterioration is largely contained in the very low end of the speculative-grade ratings universe, which is populated mainly by sponsor-owned health care services companies. Regarding consumer products, the negative outlooks reflect persistent inflation, some weakening of consumer demand and a greater proportion of discretionary products manufacturers in the region.

On the other side, the oil and gas sector has the biggest net positive bias at 21.1%, followed by forest products and building materials at 10.6%, and metals, mining, and steel at 8.9%. Healthy oil and Title Transfer Facility (TTF) natural gas prices, robust refining margins, and financial discipline that limited production growth allowed oil and gas companies to garner strong netbacks and cash flow. For building materials, we expect conditions will remain broadly stable in 2024 as demand for nondiscretionary products, including roofing, persists, while considerable parts of the sector benefit from infrastructure-related spending.

The U.S. office sector is under intense pressure given a slow return to office, tighter access to capital, and a sharp increase in funding costs. As a result, the credit quality of many office REITs has deteriorated significantly. About 40% of rated office REITs are speculative-grade, compared with 20% for the broader rated REITs portfolio. We expect ratings pressure to persist in 2024 given that about 55% of ratings on the office sector have a negative outlook.

Chart 6

U.S. nonfinancial corporate ratings outlook distribution and net outlook bias



Data as of Dec. 31, 2023. Net outlook bias—Percentage of issuers with a positive outlook or CreditWatch placement minus those with a negative outlook or CreditWatch placement. Source: S&P Global Ratings.

Cross-Sector Key Themes

We expect a modest rebound in revenue and EBITDA among U.S. nonfinancial corporates (see charts 7a-7d). Some sectors may see a turnaround after grappling with cyclical and secular challenges. For example, the media sector could improve EBITDA and cash flow this year, as losses for streaming services decline and content production returns to normal. We expect global IT spending to grow a robust 8% with material improvement in the PC, smartphone, and semiconductor segments.

Chart 7a

North American corporate revenue growth

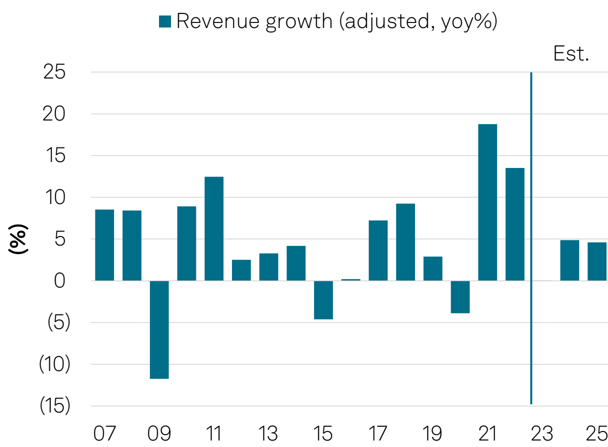


Chart 7b

North American corporate EBITDA growth

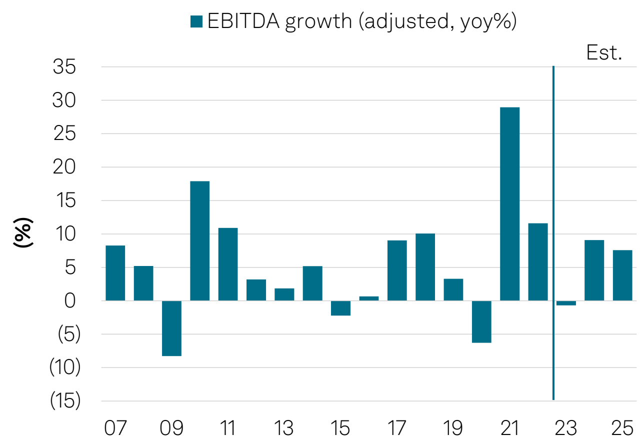


Chart 7c

North American corporate revenue growth by sector

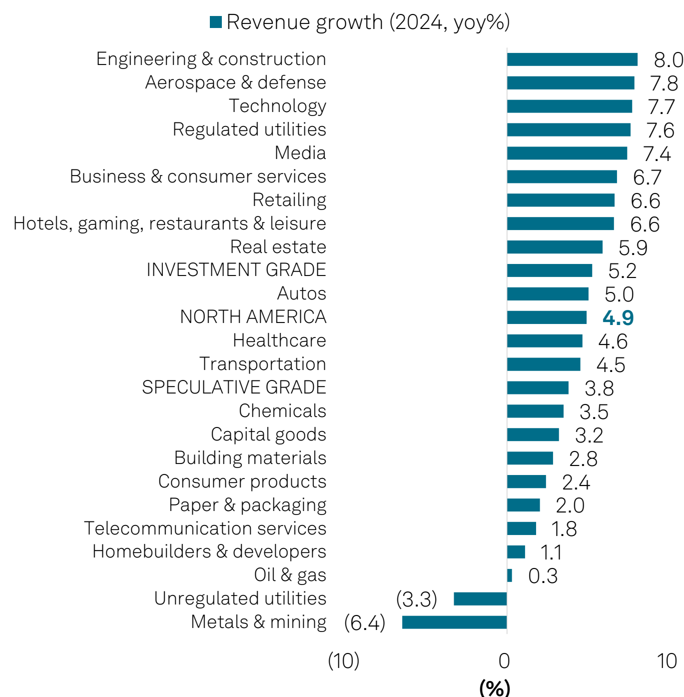
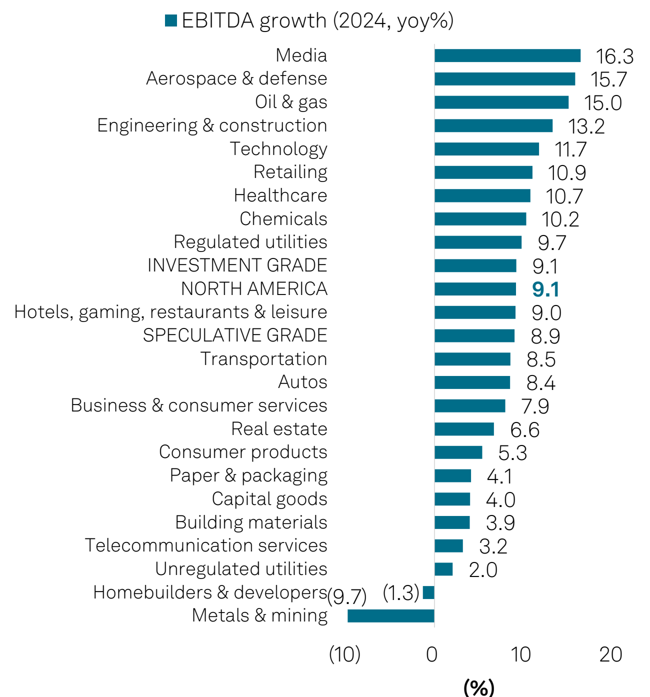


Chart 7d

North American corporate EBITDA growth by sector



Est.—Estimate. yoy—Year-on-year. Includes North American nonfinancial corporations currently rated by S&P Global Ratings. Calculated in US$ terms. Source: S&P Global Ratings.

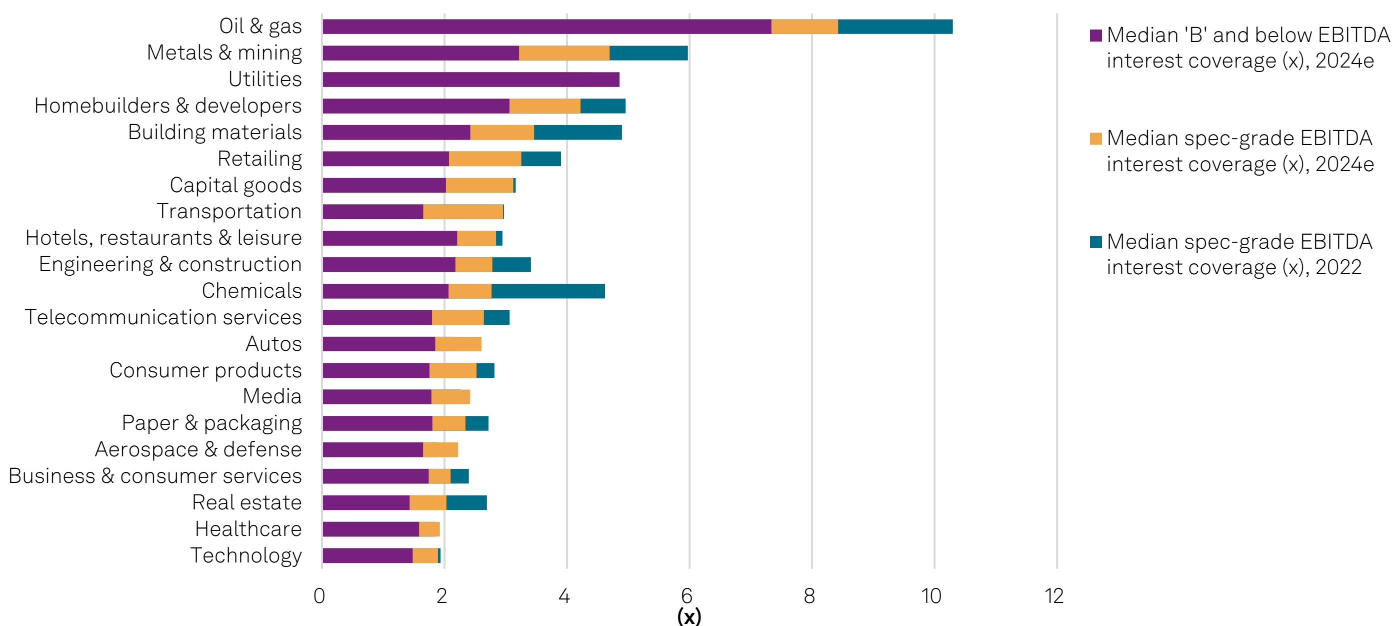
Consumer resilience will be tested this year, and sectors exposed to discretionary spending could fare worse. Travel and leisure spending growth will likely moderate as high prices and rates eat into purchasing power. As a result, sectors such as hotels and gaming may see their earnings growth slow from the strong recovery in 2023. As consumers become more selective and look to trade down, we expect relatively flat top lines for retailers exposed to discretionary spending and low- to mid-single-digit growth for those that sell nondiscretionary goods, such as grocers. On the other hand, sectors such as metals and mining, and oil and gas could see their revenues come off record levels.

The elevated cost of capital remains a top concern

Higher costs of capital threaten lower-rated businesses that have limited or volatile earnings. Lower-rated companies tend to be smaller, less diversified, and more highly leveraged. They also tend to have the more restrictive capital structures that incorporate security and variable interest rates on their debt. These have translated into higher sensitivity to rising interest rates as they more quickly strain resources available to service their debt. The impact on capital-intensive industries, or those subject to rising input or labor costs, led to a more than doubling in 'D' and selective default ('SD') ratings last year compared with 2022 or 2021. We expect EBITDA interest coverage ratio to shrink for speculative-grade issuers across majority of the sectors compared with 2022, the onset of the monetary tightening cycle (see chart 8).

Chart 8

North American spec-grade corporates' interest coverage ratio



e—Estimate. Includes North American nonfinancial corporations currently rated by S&P Global Ratings. Calculated in US$ terms. Source: S&P Global Ratings.

Investment-grade issuers, too, may face sharp increases in interest expense when refinancing. Many of the largest and highest-rated issuers had significant amounts of debt with near-zero rates. Even if they are protected by ample interest-coverage cushions, this can still mean interest expenses will increase by many orders of magnitude after refinancing. These types of companies typically have more levers to pull to address a new financing environment, but they're not immune to shifting capital markets. Cutting spending to build up cash that can then be applied to

shrink balance sheets has been used to mitigate rising interest expense. However, this isn't always sustainable, and we don't expect interest rates to come down until the second half of the year; we also think they'll remain relatively high for quite some time.

Certain sectors are particularly sensitive to high rates because of demand-side effects. Sectors such as building materials, homebuilders, real estate, and even autos face these higher costs of capital and depend heavily on end markets that rely on rate-sensitive financing to drive demand. In certain cases, companies in this situation are getting a reprieve in the form of moderating input costs, but others continue to struggle as demand weakens.

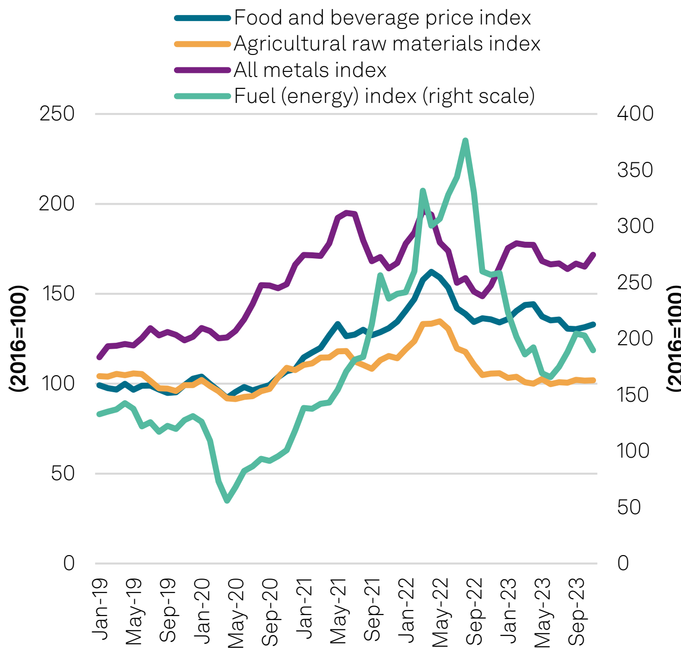
The maturity wall for corporate debt appears broadly manageable in the near term, even though maturities loom in coming years. Although many companies built in buffers, pushing maturities out during the stretch of especially favorable financing conditions in 2020-2021, refinancing pressure is building. This year's U.S. nonfinancial corporate debt maturities total $581 billion, with investment-grade accounting for 76%. However, annual maturities of corporate debt continue rising and surpass $1 trillion in 2028, when the majority of debt maturing is speculative-grade (see chart 2 on page 2). Although financing conditions have presented challenges for lower-rated borrowers, leveraged finance issuance in 2023 still exceeded upcoming annual maturities through 2027. However, as companies tend to refinance their debt 12 to 18 months in advance, rising maturities will add to refinancing pressure.

Labor pressures persist; pricing power diminishes

Some input costs pressures are easing. Key commodities prices have come off their recent peaks, but many of them remain higher than pre-pandemic levels (see chart 9). Average rates on container freight have also fallen since late 2022, to levels close to historical averages. We expect rates will remain under pressure as overcapacity looms—even with the near-term disruptions to Red Sea shipping and lower capacity at the Panama Canal due to drought (see chart 10).

Chart 9

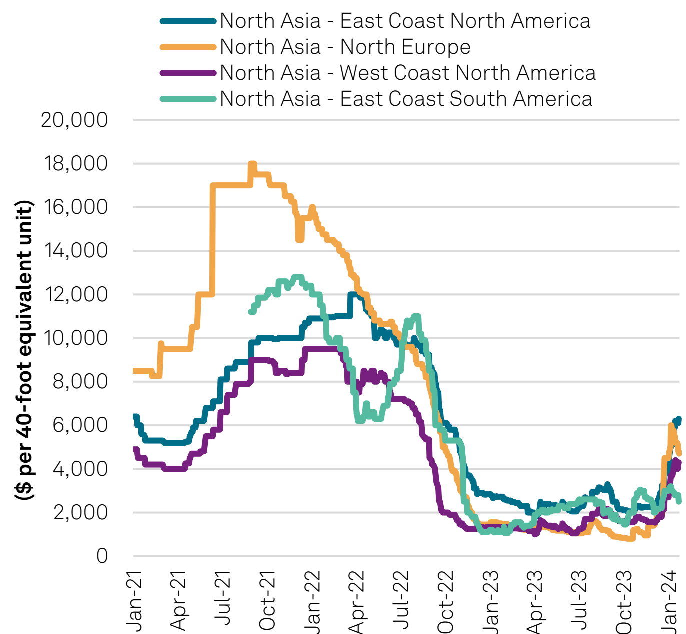
Commodities prices have come off recent peaks



Monthly data through November 2023. Source: IMF.

Chart 10

Shipping costs have spiked due to disruptions



Daily data through Jan. 26, 2024. Source: S&P Global Commodity Insights.

On the other hand, labor and wage pressures continue to proliferate. After the recent ratified agreement reached with the United Auto Workers, higher labor-related expense will lead to multi-billion-dollar annual incremental additional costs for U.S. automakers. This will lead to even higher reliance on ongoing cost-reduction efforts and lower spending on self-driving related businesses to avoid a large margin decline in 2024 and 2025. Labor costs are also on the rise for airlines, notably following a significant pilot wage increase in the U.S. The transportation infrastructure sector is also confronting headwinds as it shifts its attention to labor negotiations for U.S. East Coast ports, given the current collective bargaining agreement expires on Sept. 30.

Meanwhile, labor remains a top challenge for the health care industry, especially for the health care services subsector. While the labor situation improved last year and hiring remains strong, in the longer term, the specialized needs of the industry and the training requirements make it challenging to find workers. By some estimates, the nursing shortage may not improve until after 2025. According to the American Medical Association, the U.S. could be 130,000 doctors short by 2030. Thus, while labor expenses for many service providers grew in the mid-single digits in 2023 versus roughly 9% in 2022, the worst may not be over.

We anticipate more difficult passthrough ability amid demand headwinds, resulting in narrower margins, especially in cases where costs have remained elevated. For example, we expect branded consumer products companies to slow their average price increases, and certain niche segments (where commodities prices have declined sharply and lower-priced alternatives are available to consumers) could see price deflation. While we expect increased promotional intensity to manage stock levels, we don’t expect branded consumer product companies to reduce selling prices directly. As we enter a period of normalization and tough competition, we expect most consumer goods companies will launch ambitious cost savings programs to improve operating efficiency, especially in their supply chains and distribution functions.

Supply chain risks linger, shrouded by geopolitical tensions

Supply chain risks remain for some. In container shipping, it's uncertain how long the recent spike in rates will last given the conflict in the Red Sea, which is forcing many ships to sail the much longer routes around the Cape of Good Hope. For airlines, with the wars in Ukraine and the Middle East continuing, fuel prices will likely remain high as OPEC+ constrains supply—although hedging is a buffer against volatile oil prices. Most European and Asia-Pacific carriers hedge fuel costs, which can give a short-term advantage versus global peers (notably in the U.S.). For defense companies, besides production capacity constraints, shortages or delays in sourcing components and labor productivity limitations could impede translating orders into sales.

Destocking and inventory reduction is a prominent theme. At a time when capital conservation is a priority, companies in consumer products and retail sectors, among others, are releasing working capital by reducing inventory. This makes sense particularly if consumer preferences have changed because of higher prices rendering current stock less desirable and if supply chain bottlenecks have been largely resoled. This trend may continue this year for building materials, capital goods, and technology (see chart 11). However, this increases the risks of disruptions if supply chain issues resurface, particularly if supply chain networks have not been diversified (which comes with its own costs).

Chart 11

Destocking may continue in building materials, capital goods and technology sectors

Roughly what percentage of companies are **adjusting their supply chain strategies** over the next three years?

How are companies planning to **change inventory levels** in 2024 compared to 2023?

	< 20%	20% - 50%	> 50%
Increase	• Business & tech services • Containers & packaging	• Autos & OEMs • Health care • Homebuilders • Pharmaceuticals • Unregulated power	
Maintain	• Media & entertainment • Gaming, leisure & lodging	• Aerospace & defense • Regulated utilities • Transportation	
Decrease		• Building materials • Technology	• Capital goods
Varies or N/A	• Metals & mining • Midstream energy • Oil & gas • Oil refineries • REITs • Telecom		• Consumer products • Retail & restaurants

Source: North American corporate ratings sector analysts' survey in November 2023. S&P Global Ratings.

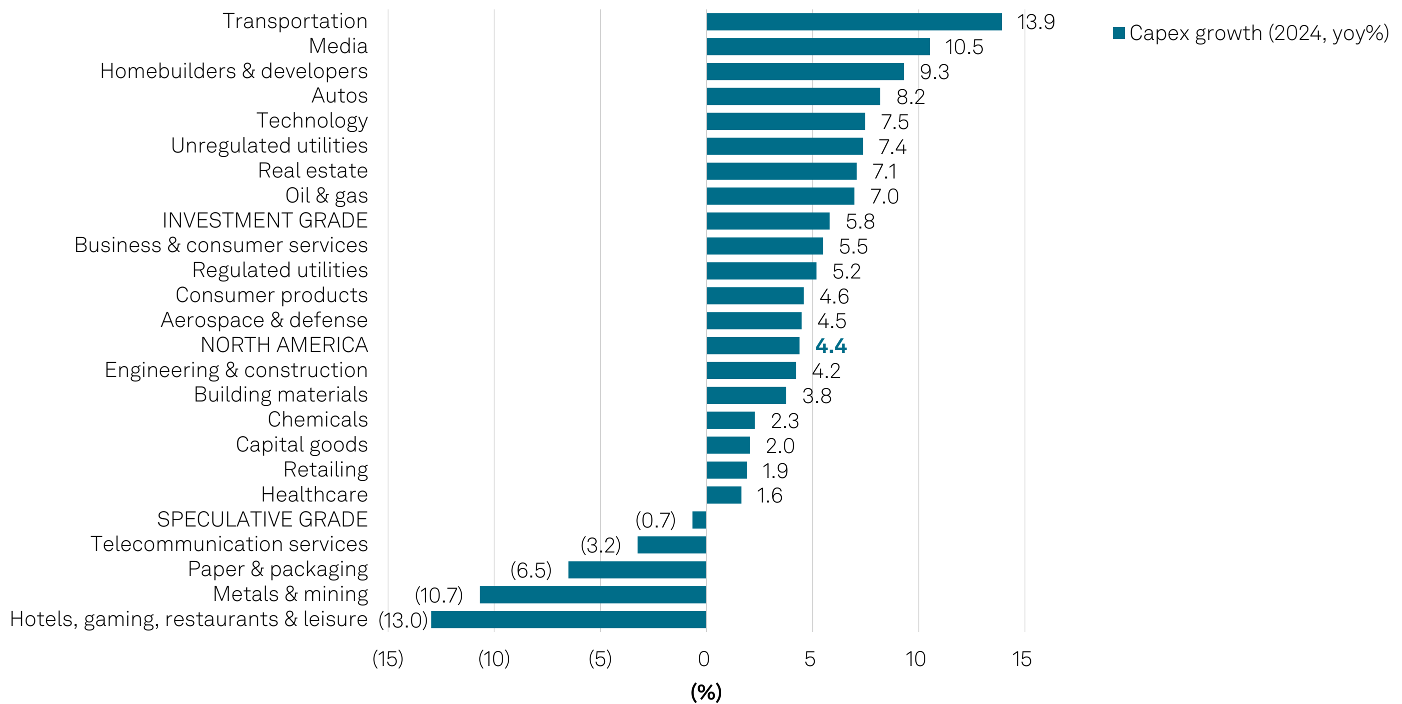
Heightened geopolitical tensions have also led to strategic shifts. Technology firms across the globe are looking to diversify their supply chains. This will lead to higher costs and reduced efficiencies because these firms must manage a more dispersed supply chain and operate in regions with underdeveloped infrastructure, higher labor costs, or more limited options of local suppliers. We estimate, for example, that the operating expenses of semiconductor giant TSMC will be 40% higher at a planned Arizona facility, versus a plant in its home market. In the auto industry, both manufacturers and suppliers have responded with increasingly local-for-local market-based approaches, which is consistent with the Western bloc's ambition to reduce dependence from Chinese dominance of value chains. In the U.S., new guidelines on restrictions embedded within the Inflation Reduction Act's (IRA's) consumer purchase credit for electric vehicles (EVs; related to component sourcing from China, Russia, Iran, and North Korea) will further limit the eligibility for the full consumer tax credits. Even before the new guidelines, only 16 of 50 battery EV (BEV) models were eligible for the full $7,500 tax credit.

Investments will likely increase to address multifaceted transitions

We expect North American capital expenditure (capex) to grow 4.4% this year (see chart 12). Uncertainty over the past couple of years led to cutbacks in capital spending and advertising budgets to hedge against skyrocketing inflation and recalibrating consumer behavior after the peak of pandemic-related spending. In certain cases, even maintenance spending was limited. Companies are now accepting the new normal and are resuming these and other necessary investments. For example, we project the media sector to incur 10.5% more capex this year, mainly driven by Walt Disney and Meta. On the other hand, despite overall normalization in capital spending this year, significantly fewer cruise ship deliveries this year compared to 2023 is leading to lower capex in the hotels, gaming and leisure sector.

Chart 12

North American capex will grow



yoy—Year-on-year. Includes North American nonfinancial corporations currently rated by S&P Global Ratings. Calculated in US$ terms. Source: S&P Global Ratings.

Corporates are also gearing up to tackle the multifaceted longer-term forces, including energy transition, technology advances and cybersecurity (see "Look Forward: Funding the Future," published Jan. 10).

Companies increasingly face physical climate risks, exacerbated by more frequent and intense natural disasters, and are deploying measures to reduce damages and improve resiliency. For example, we expect investor-owned utilities—especially those in the western U.S.—to develop detailed wildfire-mitigation plans that reduce damages, minimize litigation risk, and expand capabilities for cost recovery. While it may take considerable time and investments for the industry to fully implement these strategies, the solutions are largely predicated on already-developed and in-use technologies such as system hardening, weather stations, public safety power shutoff programs, vegetation management, etc.

Energy transition continues to be a strategic priority and a potential credit concern across many industries. For legacy automakers, we expect the transition to EVs could dilute cash flows until at least 2026. Despite the likelihood of a bumpier trajectory, essentially due to an average global price gap of more than 20% between BEVs and traditional vehicles, we see electrification as an irreversible long-term trend. In metals and mining, steel and aluminum capital spending is higher, with the focus shifting toward future-facing commodities and critical minerals, as companies invest to transition to a lower-carbon footprint or to supply growing market segments. Adding capacity in mining is expensive, with large-scale mines typically requiring several billion dollars of capital and more than a decade to develop.

For upstream and midstream energy companies, increased government regulation around climate change and greenhouse gas emissions remains a significant headwind. Meanwhile, some companies in the capital goods sector are poised to benefit from the energy transition. For

example, General Electric's order book has benefited thanks to the IRA, and the nascent turbine industry is beginning to mature and trend toward break-even at major renewables equipment manufacturers following recent losses.

On another front, **many companies are seeking to invest significantly in technology**, such as digitalization and artificial intelligence (AI), to gain a competitive edge. The semiconductor industry will likely see a strong rebound this year as memory fundamentals improve and the AI investment cycle generates strong growth for some issuers, offsetting muted demand across the rest of the market. Despite relatively gradual adoption of AI among media companies, we expect a wide range of use cases in the near term. This includes improvements to workflow efficiencies, developing scripts, and creative campaign delivery. Digitalization helps generate operating efficiencies and cost savings, but cyberattacks are becoming more widespread in sectors such as consumer products and utilities, requiring a well-tested cybersecurity playbook.

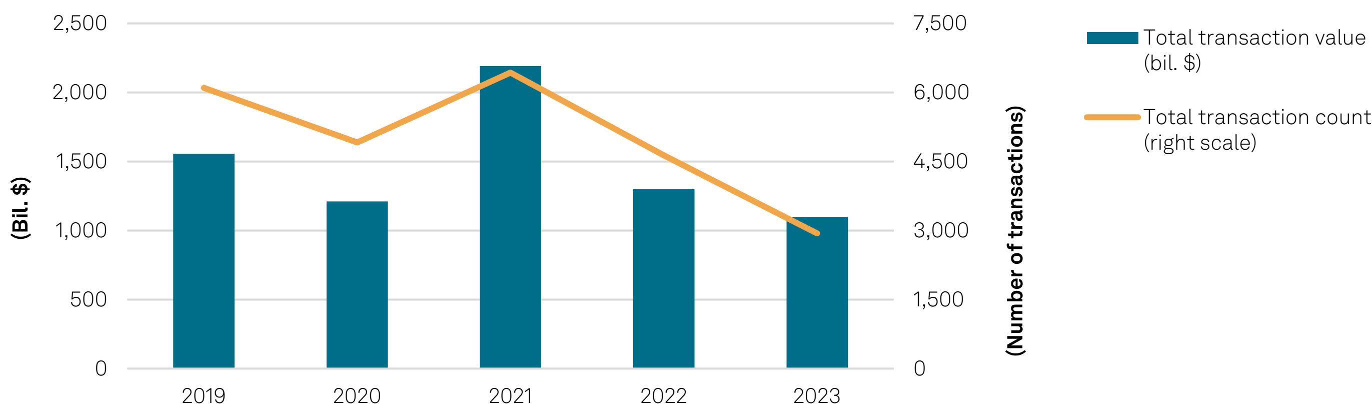
The significant expenses companies are incurring to deal with different longer-term transitions will likely mean higher costs, and potential project execution problems such as budget overruns and delays could also drag on financial performance and credit quality.

M&A may come back amid more regulatory scrutiny

For a few sectors, we expect mergers and acquisitions (M&A) to increase after a relatively quiet period (see chart 13). For example, we continue to view M&A as strategically important for the highly rated pharma and biotech companies, despite increased scrutiny by the U.S. Federal Trade Commission (FTC), with the concerns that consolidation in the industry has contributed to the rise in health care costs. However, health care acquisitions may take longer to complete. In the tech sector, as well, we believe there is pent-up demand for deal making, although large deals will continue to face hurdles, as regulators have been focused on antitrust concerns.

Chart 13

U.S. corporate M&A activity remained muted in 2022-2023



Data compiled Jan. 25, 2023, and includes U.S. corporate M&A deals announced between Jan. 1, 2019 and Dec. 31, 2023. Only includes announced/effective/closed deals for which transaction value is available. Source: S&P Global Market Intelligence Capital IQ.

There are consolidation opportunities for the hotel sector, which remains fragmented, cyclical, and highly competitive. Companies that have cushion in leverage measures for ratings may use it up doing deals. M&A potential is also present in the branded hotel space. Choice Hotel's bid for Wyndham is one example of a potentially highly leveraging transaction, which led us to place Choice's ratings on CreditWatch with negative implications. In capital goods, we expect M&A will continue this year as companies embark on portfolio transformations and strategic objectives aligning with longer-term growth, stability, and profitability.

Leveraged Finance

Sentiments for leveraged finance markets appear more positive heading into 2024, with loan issuance improving after the Fed signaled the next move in policy rates will likely be down. Nonetheless, the par amount of the Morningstar LSTA U.S. Leveraged Loan Index shrank in 2023 for the first time since the Global Financial Crisis. While the contraction was minimal, at 1.1%, the institutional loan market lost business to more welcoming high yield and private credit markets.

From a leveraged loan issuance standpoint, 2023 was only marginally higher than 2022, when issuance was at its lowest in over a decade according to LCD. The bulk of the loans issued in 2023 were for refinancing as companies tapped select windows to refinance their loans to address their 2024 and 2025 loan maturities for the most part. A general risk-off sentiment characterized the credit markets in 2023 amid uncertainty about the direction of rates, divergent views on valuation, and constrained M&A and leveraged buyout (LBO) activity. Loan issuance to support M&A, LBO, and other non-refinance activity was the lowest since GFC, according to LCD.

Refinancing by companies rated 'B' or higher to address pending maturities (mostly 2026 loans) will likely drive 2024 issuance. Based on IHS data, an aggregate $283 billion in loans rated 'B-' and above are due in 2025 and 2026. We also expect amend-and-extend transactions (which had record volumes in 2023) will continue to address approaching maturities. While there is some optimism around credit markets opening given the recent rally, we expect non-refinance-related volumes for companies rated 'B-' and lower to be subdued as broadly syndicated CLO managers continue to focus on de-risking their collateral pools.

Loan spreads have compressed to their lowest levels since early 2021. The combination of narrow spreads, with the markets rallying (over 40% trading above par) and low loan supply (given muted LBO and M&A transactions), has seen the most repricings in January, the highest in almost three years, according to LCD. We expect the continuation of this trend, but repricing will likely be capped as most loans repriced to date were from the 2022/2023 loan vintage, when spreads were higher. Spreads need to compress more, or loans rally more for further repricing.

During 2023, there was a continued trend of entities refinancing from the syndicated loan market to the private credit market. While this transition mostly covered companies rated 'B-' (or lower), we also saw a few marginally higher rated entities that transitioned to private markets. Given challenging conditions for lower-rated issuers, this trend of a select category of companies tapping the private credit markets to refinance will likely continue.

Although credit spreads and availability have improved, we expect a persisting divergence in credit performance this year, both between and within ratings categories. Expected challenges include slowing economic growth, the lagged effect for when eventual rate cuts translate into reduced debt-servicing costs, and sizable debt maturities for many low-rated companies. These factors are taking a toll on the earnings, cash flow, and liquidity of many of the most vulnerable companies (i.e., issuers rated 'B-' or lower). These issuers account for a substantial 36% of the speculative-grade universe, and many face downgrade risk, resulting in our expectation that the credit quality of many speculative-grade companies will remain under pressure in 2024.

The credit outlook and metrics of our most vulnerable issuers are extremely weak. For instance, more than 40% of these issuers have negative rating outlooks, 55% are experiencing free operating cash flow (FOCF) deficits, and 38% have less than 1x interest coverage. Moreover, many of them decreased their capital investments and working capital to preserve liquidity, which could limit their ability to grow into their debt capitalizations. Notably, sectors like health care, media and entertainment, technology, and consumer products have the highest concentration of our most vulnerable issuers.

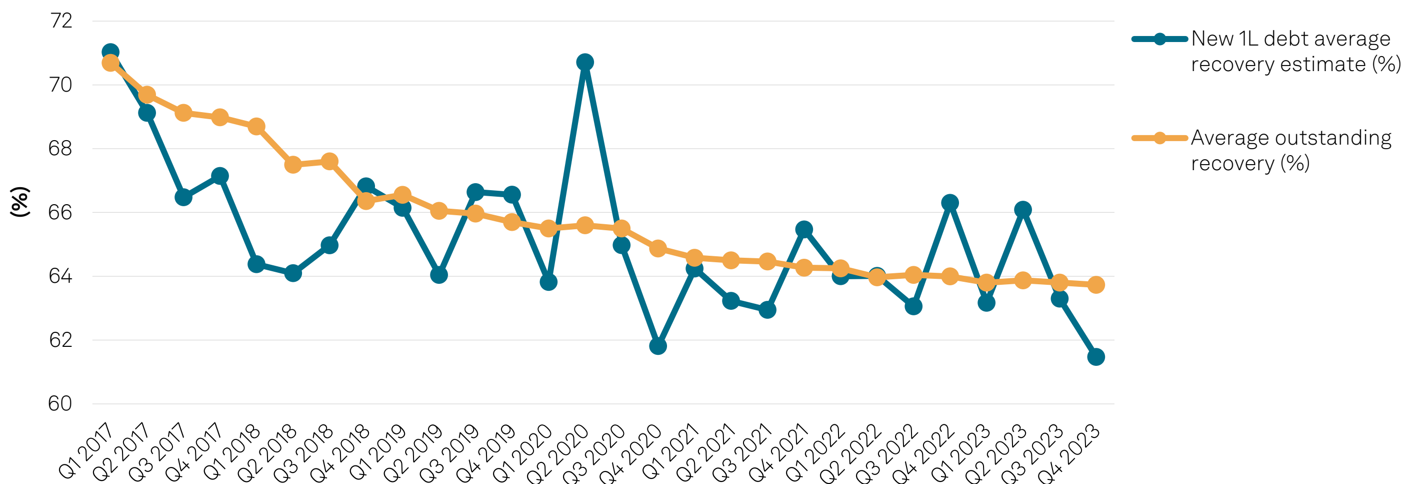
Many vulnerable issuers raised capital during a period of ultra-low interest rates and high valuations. While many of these issuers' underlying businesses remain sound, we anticipate increased amend-and-extend transactions that provide a temporary financing bridge. We also expect some issuers to struggle to obtain strategic growth investment capital, with distressed exchanges and bankruptcies remaining elevated in the next 12 to 24 months. We believe private credit will play an increasingly important role in supporting vulnerable businesses of higher quality, which require bespoke credit solutions—or much more time to support the growth and maturity of their platform.

As we enter 2024, first-lien creditors are nervous about recovery-given-default, with speculative-grade default rates now exceeding the long-term historical average after climbing steadily last year. One concern is that speculative-grade issuers are now more leveraged and first-lien heavy after nearly a decade of historically low interest rates, a welcoming institutional loan market, and sizable M&A activity based on high purchase price multiples. This has gradually lowered expectations for recovery-given-default for first-lien lenders, as indicated by the rounded point estimates that are part of our recovery ratings (see chart 14).

Chart 14

First-lien recovery expectations are now well below historical averages

Expected recovery on newly issued and outstanding first-lien debt (U.S. and Canada)



Data through Dec. 31, 2023, based on the rounded point-estimates included in our recovery ratings for rated nonfinancial corporate entities in the U.S. and Canada. Source: S&P Global Ratings.

First-lien recovery rates may be further pressured if interest rates remain elevated (which will keep pressure on valuations and cash flows) and if our forecasts for weak economic growth in 2024 and 2025 materialize.

Moreover, the rise in liability management transactions in recent years provides another threat to first-lien recovery prospects. Over this time, we've seen aggressive loan restructurings impair materially—and in some cases wipe out recovery prospects for first-lien lenders who did not sponsor or participate in these transactions. These tactics are likely to continue to be used as companies and/or aggressive lenders possibly seek to extend distressed companies more time. We note, however, that these tactics rarely seem to solve the capital structure problems that led to these restructurings in the first place.

Related Research

- U.S. Business Cycle Barometer: Recession Risk Moderates, But Growth Is Limited By Potential, Jan. 26, 2024.
- Global Financing Conditions: Cautious Optimism After Peak Rates, Jan. 25, 2024
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- Interest-Cover Risks Are Growing For Vulnerable Corporate Credit, Oct. 26, 2023

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