

Global Credit Conditions:

Trade Casts A Global Shadow

July 1, 2019

Key Takeaways

- **Overall:** Trade tensions are casting a shadow on the global economy and financing conditions in all regions. On the bright side, central banks stand ready to stimulate growth, and borrowers around the globe continue to enjoy fairly benign credit conditions.
- **What's changed:** Escalating trade strife has heightened fears that economic conditions have worsened, with signs that businesses are curbing spending and financial market sentiment surveys weakening.
- **Financing conditions:** As central banks—including the U.S. Federal Reserve and the European Central Bank—take more-dovish stances, issuers in many regions stand to benefit from declining benchmark borrowing costs.
- **Macroeconomic conditions:** While we see little chance of recession in the world's biggest economies in the next 12 months, the prospects for GDP growth have dimmed somewhat, given the direct—and, more importantly, secondary—effects of trade tensions.

(Editor's Note: S&P Global Ratings' Credit Conditions Committees meet quarterly to review macroeconomic conditions in each of four regions (Asia-Pacific, Latin America, North America, and Europe, the Middle East, and Africa). Discussions center on identifying credit risks and their potential ratings impact in various asset classes, as well as borrowing and lending trends for businesses and consumers. This commentary reflects views discussed in the four committees on June 24, 2019.)

Trade tensions—in particular the tariff dispute between the U.S. and China—are casting a shadow on the global economy and financing conditions in all regions. On the bright side, central banks in the world's biggest economies stand ready to goose growth with interest-rate cuts, and borrowers around the globe are still enjoying a historic run of benign credit conditions.

In the **U.S.**, escalating trade strife has heightened fears that economic conditions have worsened, with signs that businesses are curbing spending and financial market volatility increasing. While most indicators of financing conditions remain largely supportive, the lending backdrop has become cloudier, hinting at a slight turn in the credit cycle. The dimming outlook for world's biggest economy has prompted the Federal Reserve to halt its string of interest-rate increases, and we could now see a rate cut as soon as September of this year. Still, the U.S. economic expansion is set to reach record length, and we see little chance of recession in the next 12 months.

In **Asia-Pacific**, too, uncertainty has returned. The year started optimistically, given the Fed's pause and Chinese authorities' willingness to loosen credit supply to avoid an economic slump. However, the recent tariff increases by the U.S. and then China have shaken investors' confidence.

On the surface, credit conditions in **Europe, the Middle East, and Africa** have stabilized and have even shown some improvement, for instance in funding costs, since the European Central Bank (ECB) and the Fed adopted more-dovish stances. But growth in the region remains subdued, and we see underlying fragility amid mounting risks and vulnerabilities. While these risks have had only limited economic or financial market consequences so far, we remain concerned that the cumulative effect could reach a tipping point for markets, and then spread to the real economy.

In general, **Latin American** countries are facing a more complex environment, as well, with political risks materializing in the largest economies. Investor confidence has wavered, and external conditions are becoming more adverse as the U.S.-China trade spat escalates. U.S. President Donald Trump has also found a powerful tool in tariff threats, which prompted Mexico to agree to stem migration from Central America to the U.S. Still, the threat of new tariffs remains if Mexico fails to reach Washington's objectives.

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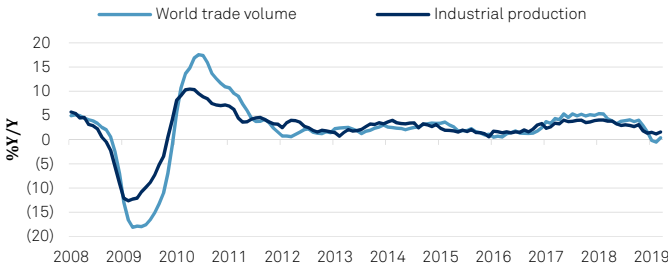
Top Global Risks: June 2019

Geopolitical and trade disputes cloud world growth

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

The world's multilateral trade framework has been shaken by key-country unilateral policy changes. U.S.-China friction has broadened from tariffs to technology. Middle East tensions pose a risk to energy markets. Such prolonged global tensions impact investment sentiment and long-term growth.

Growth In World Trade, Industrial Production Still Weak



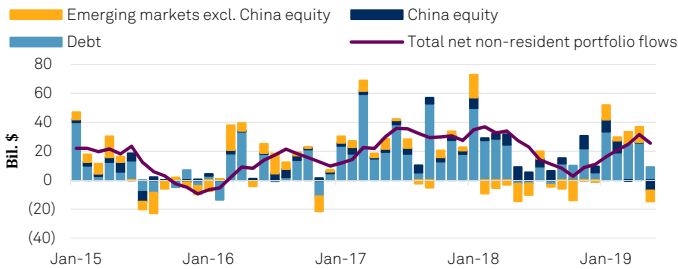
Source: CPB Netherlands Bureau for Economic Policy Analysis, World Trade Monitor.

Emerging market vulnerabilities

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

As global GDP slows rising investor demand for safe assets could expand credit spreads, spark capital outflow pressures and squeeze funding liquidity. But foreign currency borrowing cost increases could be tempered by major central banks poised to ease slightly (the Fed) or keep policies unchanged (the ECB).

Non-resident Portfolio Flows Into Emerging Markets



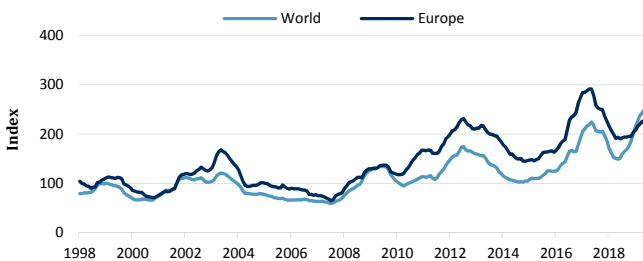
Source: Institute of International Finance.

Populism, political cohesion and policy uncertainty

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

Populists in Europe and (increasingly) elsewhere continue to challenge centrist parties creating a more fragmented and divisive political landscape with the risk that multilateral institutions lose support, policy is less predictable and governments become less willing to respond in a timely basis to emerging crises.

Economic Policy Uncertainty



Source: Economic Policy Uncertainty. EPU indices reflect normalized relative frequencies of own-country newspaper articles that contain all of the words economy, policy and uncertainty.

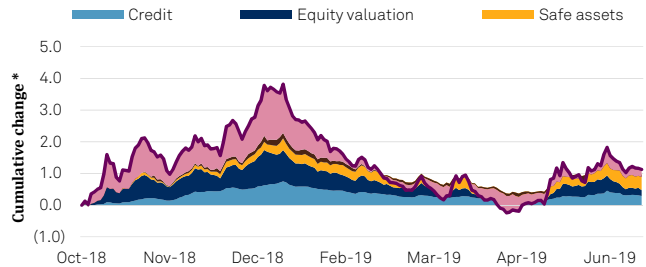
* Risk level may be classified as very low, moderate, elevated, high, or very high. It is evaluated by considering both the likelihood and systemic impact of such an event occurring over the next one to two years. Typically these risks are not factored into our base case rating assumptions unless the risk level is very high. Risk trend reflects our current view on whether the risk level could improve or worsen over the next twelve months. Source: S&P Global Ratings.

Mature credit cycle and volatile liquidity

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

The Fed's dovish policy bias is supporting liquidity and extending a mature credit cycle. Still, the build-up in nonfinancial corporate debt and leveraged lending in the U.S. and elsewhere is a source of instability. Risk aversion and measures of financial stress are inching up again after easing from 2018's extreme levels.

Stress In Global Financial Markets



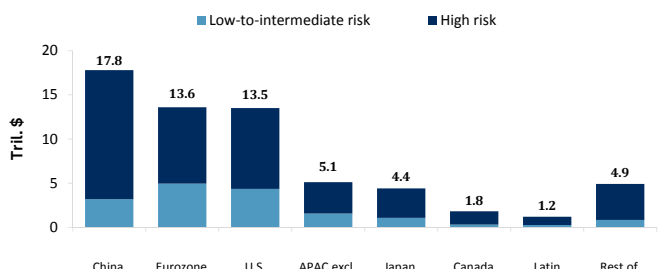
*Change in Financial Stress Index and components since September 2018. Index values above zero indicate rising financial stress. Source: U.S. Treasury Department, Office of Financial Research.

China's leverage

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

China's recent credit loosening temporarily pauses previous measures aimed at reducing leverage in the economy (on a debt-to-asset basis). The government's careful policy easing should be enough to put a soft floor under economic growth later this year and contain financial stability risks from China's debt overhang.

Nonfinancial Corporate Debt



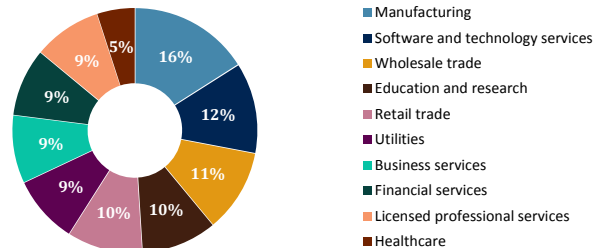
Sources: Bank for International Settlements, S&P Global Market Intelligence, S&P Global Ratings.

Cybersecurity threats to business activity

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

Increasing technological dependency and global interconnectedness means cyber risk poses a systemic threat and significant single entity risk. Companies face the risk of criminal, proxy and direct state-sponsored cyber-attacks.

Widespread Cloud Usage Across Sectors Highlights Systemic Dimension Of Cyber Threat



source: Lyence.

Financing Conditions

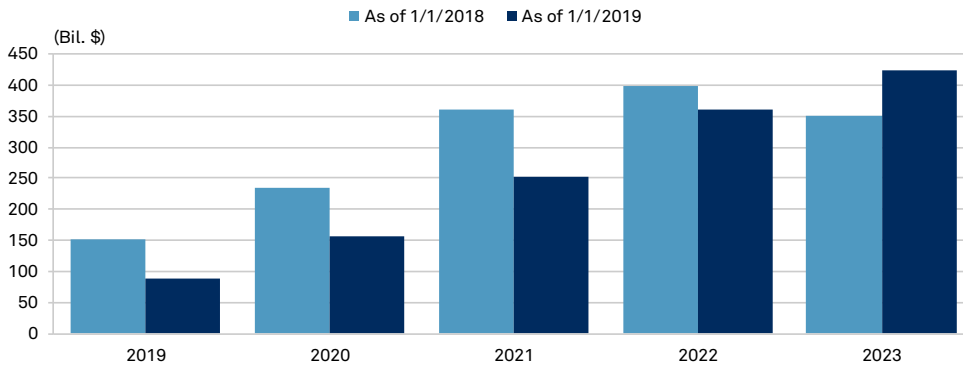
A shift in guidance from the U.S. Federal Reserve and the ECB has brought further sharp falls in the cost of bond-market funding, with 10-Year Treasuries falling below 2% at the end of June and U.S. BBB corporate spreads down around 40 basis points since the start of the year. With the Fed now expected to cut its policy rate this year and the ECB actively considering how it might respond to below-target inflation rates and sub-zero eurozone 10-year bond yields, global lending conditions are likely to remain fundamentally supportive.

A renewed focus on stimulus from the Fed and ECB is supporting financial conditions

That said, risks around the economic cycle have grown with slowing growth rates and deteriorating sentiment apparent across a variety of leading indicators. Flattening or inverted yield curves may make it harder for central banks to stimulate lending given pressure on banking sector profitability and the ongoing uncertainty created by trade and political tensions are prompting occasional bouts of market volatility. Nevertheless, our base case view remains that loose monetary conditions, augmented in the case of the U.S. by further stimulus, will help prolong the economic and credit cycle through the course of the year.

We estimate that **U.S.** speculative-grade spread should be wider, based on various economic and financial indicators—implying that financial markets are overly optimistic. That said, the maturity profile for U.S. spec-grade issuers appears largely manageable (see chart 1). Issuers have been paying down debt at a steady pace, and after a rough patch to start the year, issuance has remained well ahead of maturities in the next 12 months.

Chart 1
U.S. Speculative-Grade Nonfinancial Corporate Maturity Wall



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

Source: S&P Global Fixed Income Research

Financing conditions for **Asia-Pacific** emerging markets overall improved early in the year, and in the Institute of International Finance’s latest survey, respondents expected lending conditions to continue to improve in the second quarter. It appears this expectation may have been optimistic. In China, funding conditions have generally eased—but not for all borrowers (see chart 2).

Chart 2
China Credit Spread Trends



Source: S&P Global Ratings

Global Credit Conditions: Trade Casts A Global Shadow

Although the demand for loans and funding conditions in Asia-Pac showed modest improvements, credit standards, nonperforming loans, and trade finance deteriorated compared with the previous quarter. These are some of the risks that might continue for the rest of the quarter.

Corporate bond issuance will likely grow this year, despite the aforementioned risks. Through May, a record \$603.8 billion came to market—up 5.8% from the same period last year.

In **Europe**, trade uncertainty and muted inflation will likely prevent the ECB from raising rates until 2021 in our view. While beneficial for borrowing and paying down debt, this also reflects underlying economic fragility and presents business challenges for banks' profitability, insurers' earnings, and activity in structured finance.

For **Latin America**, we expect financing conditions to remain fairly favorable in light of potentially lower interest rates in the U.S. and other advanced economies. In our view, investors will be more selective and looking for the issuers with more solid fundamentals, given the subdued economic prospects. While the pace of bond issuance has quickened in recent months, the total amount—\$28.5 billion as of June 17—is the lowest in 13 years. Refinancing appears manageable in the next few years, although additional strains among less creditworthy borrowers will most likely surface.

Macroeconomic conditions

Of the 10 leading indicators of near-term U.S. economic growth S&P Global Ratings tracks in our monthly Business Cycle Barometer, five are positive, three neutral, and two negative. Deceptively strong first-quarter U.S. GDP growth was largely driven by an inventory build-up and net export strength as businesses tried to get ahead of protectionist trade actions. A closer look shows the economy is cooling. That said, the expansion in the world's biggest economy is about to reach record length, and we see little chance of recession in the next 12 months.

The top threat to what has been a prolonged run of benign credit conditions in **North America** is the uncertainty around trade—in particular, the Trump Administration's tariff war with China. While the dispute will likely have minimal direct macroeconomic effects on either country for now, the longer-term consequences for global supply chains, U.S. business sentiment, and consumers' purchasing power are growing. The U.S.'s 25% tariffs on Chinese imports, combined with retaliation from China, will directly shave off about 30 bps from U.S. growth in the next 12 months—perhaps a bit more in secondary effects such as tighter financial conditions and reduced business investment.

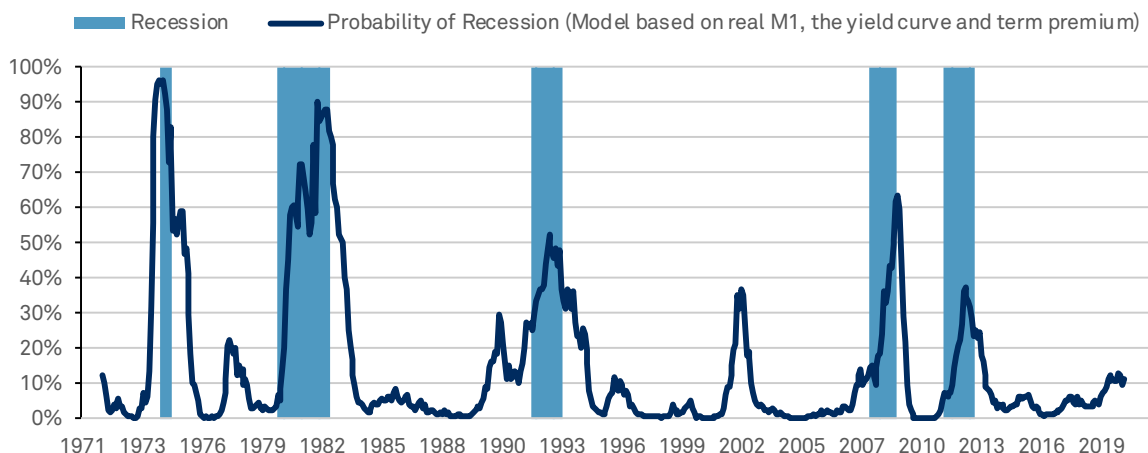
This has also fostered uncertainty in **Asia-Pacific's** credit conditions. Investment growth across the region's trade-dependent economies—including Korea, Malaysia, and Singapore—has fallen to a seven-year low. For China, investment in technology-related manufacturing is expanding at its lowest level since at least 2004 (investment is still growing, but at slower pace).

The **eurozone** economy surprised on the upside in the first quarter, with GDP growth expanding by 0.4% on the quarter. In spite of weak global trade dynamics, with net trade added a little to growth. But what really boosted the economy was the strength of domestic demand—which added 0.5 percentage point to growth. As it stands, we see little chance of recession in the eurozone in the next 12 months (see chart 3)

Trade and political tensions pose the greatest near-term threat to the economic cycle

Chart 3

**Eurozone Recession Probability Is On The Rise
But Still Marginal, Being Close To 10% In The Next 12 Months**



* Model based on real M1, the yield curve and term premium
Source: CEPR, ECB, S&P Global

While the weakness of global trade continues to weigh on European manufacturing, a strong labor market is underpinning demand in the services and construction sectors. Headline unemployment in the eurozone dropped to 7.6% in April—ever closer to its record low of 7.3%, seen in 2008. Considering that job vacancies have reached a historic high, it seems that structural and consequently lasting trends are supporting labor markets. A tight labor market is not only adding to household income through job creation, but also through higher wages. Adding to that, inflation remains low, and thus households are set to see their purchasing power expand further.

The story is less rosy in **Latin America**, where several external and domestic downside risks have materialized, prompting us to lower our GDP growth expectations for most economies in the region. Externally, a further escalation in the trade conflict between the U.S. and China has increased risk aversion and renewed pessimism about global growth—a setback for investment in Latin America. The political landscape has become more difficult in several countries in the region, especially in Argentina and Brazil, further weighing on investment conditions.

With the Fed’s expected cut of a quarter-point this year, lower interest rates in the U.S. will likely be a positive development for Latin American assets by encouraging capital inflows into the region. There are a couple of things that could prevent this from happening: first, financial markets are pricing in two 25 basis point cuts, so the risk is that the Fed doesn’t match financial markets’ expectations; second, any policy easing suggests growing concerns over global growth, which in itself could discourage, rather than encourage, investment in Latin America, especially in countries where growth is already low and political risk is high.

Related Research

- Credit Conditions Asia-Pacific: Return Of Uncertainty, Jun. 27, 2019
- Credit Conditions EMEA: Double, Double Toil and Trouble, Jun. 27, 2019
- Credit Conditions Latin America: Optimism Fades Despite Fed’s Pause, Jun. 27, 2019
- Credit Conditions North America: Trade Tensions Cloud The Outlook, Jun. 27, 2019

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