

Credit Conditions:

Trade Tensions Begin To Weigh On Conditions In Some Regions

September 27, 2018

Escalating trade tensions--between the U.S. and China, in particular--are heightening the risks to the historic run of benign conditions that borrowers around the globe have enjoyed for nearly a decade. And, in fact, conditions have worsened marginally in some regions.

S&P Global Ratings' top global risks include the possible interruption of trade and investment as the U.S. escalates trade skirmishes on a number of fronts; increased asset-price volatility and the possibility of liquidity reversals; and the threats that a buildup in debt poses to the U.S. credit cycle. (For an infographic detailing our top global risks, [click here](#).)

Table 1

Top Global Risks

Trade and investment interruption	The latest salvo in trade tensions will see tariffs hit an additional \$200 billion of U.S. imports from China. The growing list of products targeted in tit-for-tat retaliation--some produced by multinationals through integrated supply chains--expands the share of global GDP exposed to trade and investment disruptions.
Asset price volatility and liquidity reversal	Rising U.S. rates, a stronger U.S. dollar, growing investor risk aversion, and capital outflow pressures continue to squeeze emerging market borrowers. Industrial commodity prices (notably metals) are softening, and global trade tensions are adding to stresses for some emerging market borrowers.
Benign U.S. credit cycle threatened by debt buildup	Declining average credit quality, along with a pickup in U.S. leveraged lending and speculative-grade bond issuance since 2012, could amplify credit stresses if investor risk aversion unwinds still compressed credit spreads, or reduces share prices and reduces market access to debt or equity financing.
China debt overhang	China's corporate sector deleveraging trend is pausing amid decelerating earnings and notwithstanding ongoing expenditure restraint. While authorities are committed to deleveraging for state-owned enterprises, they are fine-tuning financial-risk reduction measures to support corporate financing.
Populism and anti-globalization sentiment	A sizable vote for nationalist parties in the 2019 European Parliamentary elections could derail any remaining momentum toward an ever closer union. It would be harder for the European Commission to object to social and economic policies that challenge EU regulations and solidarity. Immigration, still a highly divisive issue, may yet undermine free movement of labor in the Schengen area.
Cybersecurity threats to business activity	Increasing technological dependency, global interconnectedness, and rapid technological change mean that cyber risk has systemic dimensions.

While credit conditions in North America remain broadly favorable, the risk that the U.S.-China

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tariff dispute will devolve into an all-out trade war outweighs the threats posed by monetary-policy normalization and the prospects for widening credit spreads for borrowers in the region.

In the latest salvo from Washington, the U.S. has imposed tariffs on another \$200 billion of Chinese imports--with tariffs of 10% rising to 25% next year, unless the two countries come to a compromise. China has again vowed to retaliate, increasing the likelihood that the White House will slap tariffs on another more than \$250 billion in goods from its largest trading partner. At that point, almost every Chinese product Americans buy would be subject to tariffs.

With regard to credit conditions, S&P Global Ratings is concerned about the indirect effects on investor and consumer confidence--as well as the risk that China will retaliate with nontariff actions, such as an unofficial boycott of American goods or limits on investment.

While the direct effects of the dispute have yet to reverberate through the U.S., credit conditions in the Asia-Pacific region have already worsened marginally. Financing conditions have tightened, and we expect continued tightening later this year. Market volatility has sent regional currencies lower and led central banks in India and Indonesia to hike rates as a precaution.

This comes as investor sentiment toward emerging markets has soured somewhat. The U.S. dollar has strengthened amid solid growth in the world's biggest economy, and rising U.S. interest rates--along with expectations for the Federal Reserve to continue to tighten monetary policy--have resulted in portfolio outflows from developing markets.

In China, corporate deleveraging has paused--mainly because of a slowdown in earnings growth rather than profligate spending or borrowing. While governmental authorities are committed to deleveraging for state-owned enterprises, they're fine-tuning financial-risk reduction measures to support corporate financing. This comes amid rising stress, especially for private enterprises, from higher funding costs and risk-aversion among lenders, given slower investment spending and weakening industrial demand. We believe the most vulnerable borrowers, in particular private enterprises, will continue to face higher refinancing and default risk.

Similarly, credit conditions in Latin America are weakening due to tighter financing conditions, U.S. dollar strength, and investors' increasing risk-aversion to emerging markets--as well as rising trade tensions and the expectation for continued interest rate hikes in the U.S. We expect episodes of capital outflows and pressure on regional currencies, and this will test policymakers across the region, whose decisions over the coming months will be crucial to support stability for issuers and investors.

In Europe, credit conditions remain favorable in the eurozone but are tightening somewhat in the U.K. ahead of Brexit. Uncertainty about how smoothly the country can extricate itself from the EU threatens to undermine business confidence and financial markets if it isn't resolved in the next quarter. Although not our base case, this increased likelihood of a disruptive Brexit is now at a level that has become a rating consideration for the most affected nonfinancial corporates. (For regional summaries, see "Credit Conditions: Regional Highlights Q3 2018.")

Regional Credit Conditions Committee Reports

- Credit Conditions: North America Q3 2018
- Credit Conditions: Asia-Pacific Q3 2018
- Credit Conditions: Latin America Q3 2018
- Credit Conditions: EMEA Q3 2018

Financing Conditions

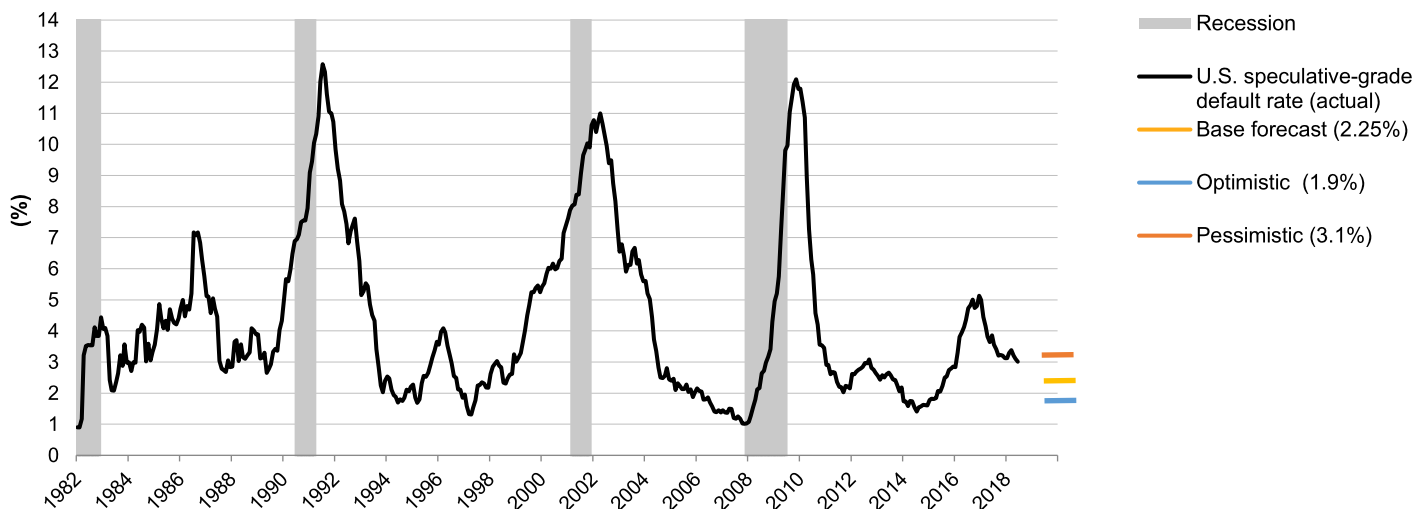
Through August, nearly all indicators of financing conditions in the U.S. remained favorable for corporate borrowers. The Fed's latest rate hike brings the benchmark federal funds rate to 2.0%-2.25%. This marks the eighth increase since December 2015, and most observers expect another at the central bank's December meeting. Though policymakers have pursued a predictable path thus far, with little impact on corporate yields, at some point higher rates will affect borrowers.

Nearly all leading indicators of near-term defaults remain benign at this point, and S&P Global Fixed Income Research forecasts the U.S. trailing-12-month speculative-grade default rate will fall to 2.25% by June 30, 2019, from 3% in June of this year (see chart 1). However, risks remain in the longer-term, including tighter monetary policy, a new tax code containing debt-detering elements that will only become more restrictive in future years, and the waning positive effects on GDP of tax reform and the recent fiscal stimulus.

We expect the U.S. speculative-grade default rate to decline to 2.25% by June 2019, but longer-term risks remain.

Chart 1

U.S. Trailing-12-Month Speculative-Grade Default Rate And June 2019 Forecast



Note: Shaded areas are periods of recession as defined by the National Bureau of Economic Research.

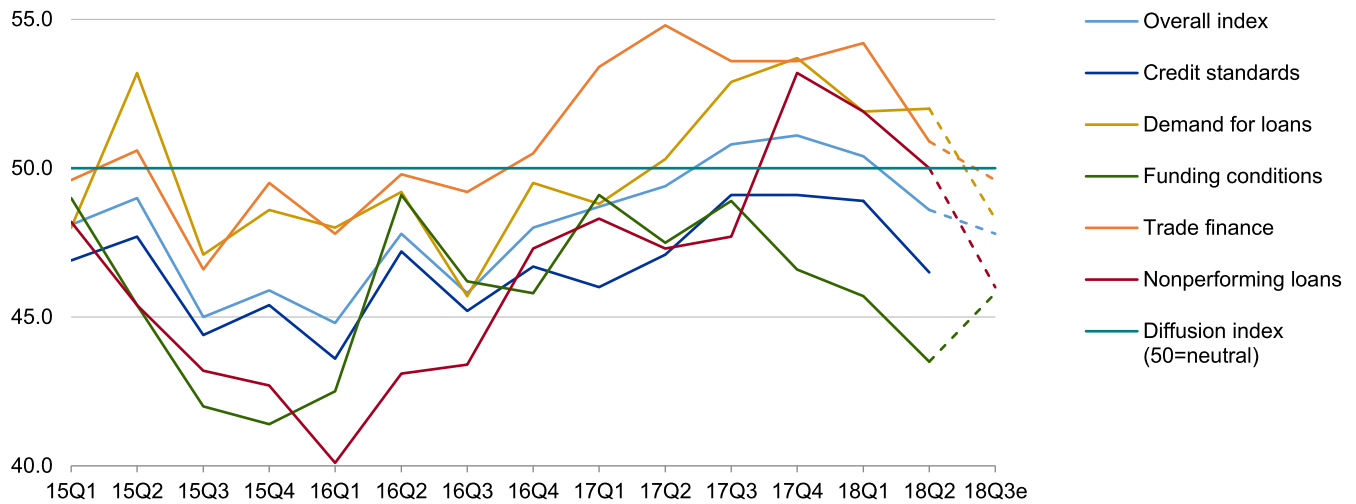
Sources: S&P Global Fixed Income Research and S&P Global Market Intelligence's CreditPro®.

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Different conditions prevail in Asia-Pacific, as financing conditions in emerging markets have tightened since the beginning of the year. The Institute of International Finance (IIF) index of overall lending conditions slumped to 48.6 at the end of the second quarter, from 50.4 the previous quarter, and many expect continued tightening later this year (see chart 2). The IIF indices, whose values above 50 imply expansive conditions, are projected to tighten in nearly every emerging market region across the globe, with the exception of the Middle East and North Africa. For emerging Asia, specifically, financing conditions are expected to deteriorate later this year--though the index teeters at 51, on the edge of expansive territory.

Chart 2

IIF Emerging Markets Bank Lending Conditions Indices



Note: Dashed line denotes expectation in the next three months. Values below 50 indicate a tightening in bank lending conditions and values above 50 indicate easing. For NPLs, values below 50 indicate a rise in NPLs and vice-versa. The 2018Q2 survey covering 94 EM banks was conducted during July 2018. e--Estimate.

Source: Institute of International Finance.

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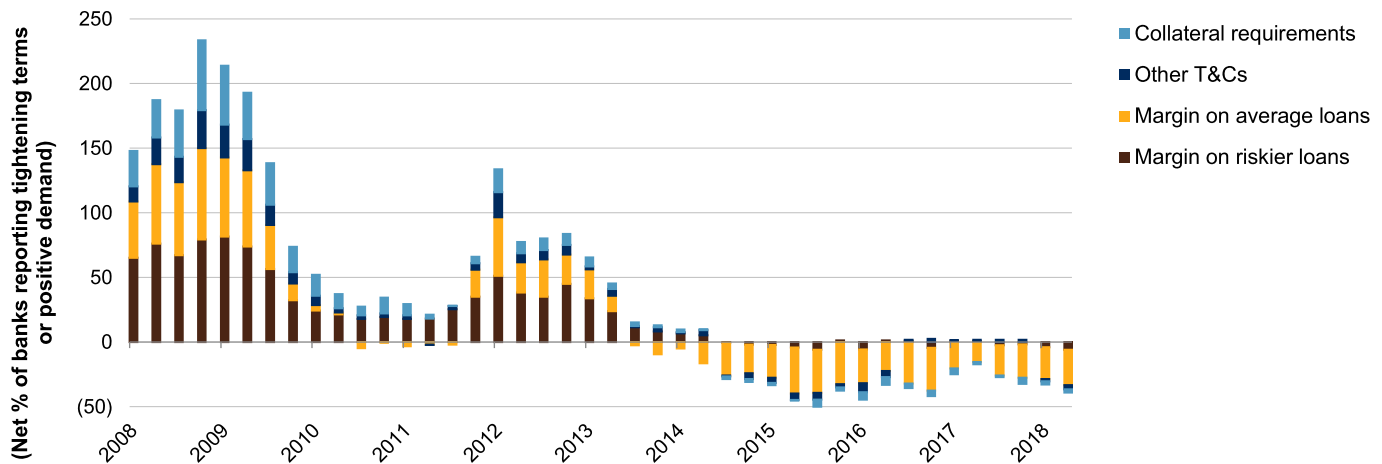
For Latin America, this means that despite the high levels of liquidity in the markets, financing conditions are deteriorating, as investors demand higher risk premiums and become more averse to emerging markets and speculative-grade borrowers. As interest rates rise, areas with higher exposure to international funding may see additional constraints with respect to capital flows, as investors may allocate capital to higher-yielding securities in developed markets, instead of emerging markets.

In the U.K., financing conditions have similarly continued to tighten for both consumers and businesses, following the Bank of England's decision to raise interest rates 25 basis points (bps), to 0.75%, in August.

However, in the eurozone, private-sector credit conditions remain borrower-friendly, with credit standards continuing to ease for loans to households and enterprises. Loan demand has continued to increase across all loan categories, with corporate demand largely being driven by investment, and mergers and acquisitions (M&A). Heightened competition among banks, reflected in narrowing loan margins, and strong balance sheets have facilitated supply (see chart 3). The substantial pickup in large debt-funded M&A transactions across the region is somewhat reminiscent of shareholder behavior seen before the financial crisis in 2006-2008.

Chart 3

Competition Is Keeping Downward Pressure On Loan Margins



Sources: ECB Bank Lending Survey (BLS) and Thomson Reuters Datastream.
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Macroeconomic Conditions

S&P Global Ratings expects GDP growth in the U.S. to remain above-trend this year and next--at 2.9% and 2.3%, respectively--bolstered by a strong labor market, still-bullish consumer confidence, and favorable manufacturing sentiment. Headline unemployment is at 3.9%, and wages are finally showing significant gains--and consumer confidence reached an 18-year high in August as core retail sales rose for a seventh straight month.

That said, the U.S. tariffs, with retaliation from China, will likely reduce economic growth this year and next. Assuming the 10% tariffs remain in place, we lowered our growth forecast for the year, albeit to a still-solid 2.9%, from 3.0% in our June forecast (and still almost 50 bps higher than our March forecast).

For Canada, our outlook for next year and beyond depends on whether business spending and trade remain growth drivers. In our baseline outlook, we see investment spending boosting growth as businesses address growing capacity constraints, retool their production platforms, and pursue growth opportunities in key markets. These investments could help lift lagging productivity growth above its long-term trend rate of 1%, keep a lid on inflationary pressures, and allow the economy to sustain growth above 2%.

For Asia-Pacific, our baseline growth outlook for the region remains broadly unchanged, given the continued solid data. However, the trade dispute's second-order effects on confidence will be key for our forward view, and these have now begun to deteriorate. Central banks in some countries are now leaning toward tightening monetary policy in order to protect their balance of payments more than for fighting incipient inflation pressures.

In short, the downside risks to our forecast are building. With the U.S. economy powering ahead, the Fed continuing to normalize, and the U.S. administration continuing to tighten the trade war

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screws, we wonder if the current benign macro picture can last.

Similarly, the macroeconomic environment has become more challenging for Latin America. External financing conditions have tightened further amid ongoing dollar strength and rising U.S. short-term interest rates. This has weighed on investor confidence toward emerging market economies with large fiscal and/or external account imbalances--especially those where domestic political dynamics create uncertainty over the government's ability to implement policies that correct those imbalances. This is notable in Brazil and Argentina--the region's biggest and third-biggest economies, respectively--and we've lowered our GDP forecasts for those two countries. We now expect Brazil's economy to expand just 1.4% and 2.2% this year and next, and we forecast Argentina's economy to contract 2% this year and remain stagnant in 2019.

Our macroeconomic outlook for the rest of the major Latin American countries has remained broadly unchanged. We still expect just more than 2% GDP growth in Mexico (the region's second-largest economy) this year and next, and trade and investor relations with the U.S. to remain strong. We also continue to expect faster GDP growth in Chile, Colombia, and Peru this year than we saw in 2017.

For Latin America, external financing conditions continue to tighten.

Table 2

Latin America GDP Growth

(%)	2016	2017	--Baseline scenario--				--Downside scenario--			
			2018f	2019f	2020f	2021f	2018f	2019f	2020f	2021f
Argentina	(1.8)	2.9	(2.0)	0.0	2.5	3.0	(3.0)	(1.5)	1.0	1.5
Brazil	(3.5)	1.0	1.4	2.2	2.5	2.6	0.7	1.2	1.2	1.2
Chile	1.2	1.6	4.0	3.3	3.0	3.0	3.5	2.5	2.3	2.3
Colombia	2.0	1.8	2.6	2.7	2.8	2.8	2.2	2.2	2.3	2.3
Mexico	2.6	2.3	2.2	2.4	2.5	2.5	1.7	1.8	2.0	2.0
Panama	5.0	5.4	4.5	5.5	5.5	5.5	3.0	4.5	5.0	5.0
Peru	4.1	2.5	3.8	3.8	3.8	3.8	3.5	3.0	3.0	3.0
Uruguay	1.7	2.7	2.4	2.7	2.9	3.0	1.8	2.0	2.2	2.4
Venezuela	(12.0)	(10.0)	(10.0)	(5.0)	2.0	2.5	(16.0)	(10.0)	(2.0)	(2.0)
Latin America	(1.1)	1.1	1.0	1.8	2.6	2.7	0.0	0.6	1.5	1.5
Latin America ex Venezuela	(0.4)	1.8	1.7	2.2	2.6	2.8	1.0	1.3	1.7	1.7

Note: The Latin America GDP aggregate forecasts are based on three-year average (2014-2016) PPP GDP weights. Our GDP numbers are based on seasonally adjusted series when available. f--Forecast. Source: S&P Global Economics.

Meanwhile, we've scaled back our growth forecasts for the eurozone to 2.0% this year and 1.9% for 2019, given increasing uncertainties around external demand. Disappointing growth and inflation figures, a widening interest-rate differential with the U.S., and mounting European political risks have weakened the euro versus the dollar. With political key issues still on the agenda--e.g., Italy's budget, Brexit negotiations, and the start of the campaign for the EU parliamentary elections--we now expect the euro appreciation to kick in later and not before the second half of next year. Trade tensions are weighing on confidence and have the potential to become more of a drag on growth if the situation escalates.

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