S&P Global Ratings

Regional Credit Conditions Chair

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Credit Conditions North America:

U.S.-China Trade Strife Threatens Favorable Conditions

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Contents

Key Takeaways

- **Overall:** Conditions remain broadly favorable, as the U.S. economic expansion continues, interest rates are increasing at a measured pace, and upcoming maturities appear manageable.
- **What's changed:** The threats to what has been a historic stretch of benign conditions are increasing—primarily the escalating U.S.-China trade dispute.
- **Risks and imbalances:** Beyond the possibility of a full-blown trade war with China and increased tensions with the U.S.'s other largest trade partners, S&P Global Ratings sees the biggest risks to North American credit conditions as: rising corporate debt, upward pressure on borrowing costs, and imbalances in Canada's housing market.
- **Financing conditions:** Conditions remain favorable, with debt issuance holding up fairly well, the corporate distress ratio at the lowest in more than three years, upcoming maturities seeming manageable, and interest rates rising at a measured pace.
- **Macroeconomic conditions:** U.S. economic momentum remains strong, and we expect the world's biggest economy to grow above-trend this year and next, underpinned by a strong labor market, and bullish consumer and manufacturing confidence.
- **Sector themes:** While the effects of the trade dispute on sectors varies—and remains somewhat muted for now—borrowers face some late-cycle credit dynamics.

(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 North America committee on June 26, 2018.)

Credit conditions for borrowers in North America remain broadly favorable, as the U.S. economic expansion continues apace, policy makers maintain a measured approach toward raising interest rates, and upcoming maturities appear manageable. But hazards facing this historic stretch of benign conditions are increasing—not the least of which is the harsh rhetoric and tit-for-tat tariff threats playing out in the U.S.-China trade dispute.

The Trump Administration's bet that it can win a trade battle with a country that last year exported more than half a trillion dollars in goods to the U.S. has spooked investors, who, after shrugging off much of the early back-and-forth, now seem more worried that a full-blown trade war is in the offing. For now, much of the reaction has been confined to equity markets, with benchmark indices becoming more volatile, while spreads on corporate debt remain fairly stable.

After President Trump instructed the U.S. Trade Representative (USTR) to consider drawing up a further list of Chinese imports (amounting to $200 billion) that could be subject to tariffs, China threatened to retaliate. But China can't match the U.S. figure because its American imports totaled just $130 billion last year. The greater threat is that the dispute could expand beyond tariffs, with China opting to pursue actions that could affect services and investments. This increases the risk of trade negotiations breaking down, as well as the chance of policy missteps.

Table 1

Top North-America Risks

Retaliatory tariffs threaten global trade and investment

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

Heated rhetoric, escalating trade tensions, and tit-for-tat retaliatory tariffs between the U.S. and its major trading partners remain a threat to global trade and investment. Companies with foreign affiliates connected to integrated supply chains could feel the impact through multiple channels if tariffs sap demand for their exports and also raise import costs for the intermediate inputs they source abroad. Higher prices for imported goods will squeeze consumer purchasing power, and domestically produced goods could cost more if companies reinvesting in onshore production displace consumer access to cheaper imports. Lower trade that reduces competition and undermines productivity could limit short-term employment gains from reshoring production.

The credit cycle is moving closer to a turning point as leverage expands

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

U.S. nonfinancial corporate debt is perched at a new high of $9 trillion, or 45% of GDP, after a lengthy period of uninterrupted credit growth stretching back to 2012. Declining average credit quality points to greater sensitivity to rising borrowing costs. The pick-up in leveraged lending and speculative-grade bond issuance is a vulnerability that could amplify credit stresses if investor risk-aversion tightens financing conditions, or reduces market access for borrowers.

Credit spread normalization could destabilize access to cheap funding

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

U.S. headline and core CPI have moved closer to the Fed's 2% inflation target along with upticks in the PCE deflator. On the other hand, inflation expectations still hovering in the 1% range are curbing upward pressure on long-term borrowing costs and adding to yield curve flattening pressures as the Fed's policy rate continues its upward climb. Increased buying of U.S. fixed income assets on capital outflow pressures for select emerging markets have limited credit spread widening and an erosion of favorable financing conditions for U.S. nonfinancial corporate borrowers. Still, risk repricing, spread widening and debt-servicing pressures remain a potential threat for highly leveraged borrowers as the Fed shrinks its balance sheet and the need for monetary policy accommodation wanes.

Housing imbalances remain a threat for Canada even as credit growth slows

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

Household credit growth is slowing in response to interest rate rises from the Bank of Canada and new mortgage lending guidelines that introduced stress test for homebuyers. The new guidelines add to numerous other government initiatives aimed at curbing risky borrowing and lending practices. Consumer debt is beginning to stabilize as a share of personal incomes and overheated demand conditions for residential real estate in Toronto and Vancouver appear to be easing. Still, with elevated price-to-income multiples squeezing home affordability and households having accumulated a record C$2.1 trillion in credit market debt, housing market imbalances remain a key vulnerability for Canada's economy. The NAFTA renegotiation and potential contagion from global trade tensions are similarly a risk for Canada's trade-oriented growth prospects.

Sources: S&P Global Ratings.

* **Risk levels** may be classified as very low, moderate, elevated, high, or very high, and are evaluated by considering both the likelihood and systemic impact of such an event occurring over the next one to two years. Typically these risks 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

Regional credit conditions

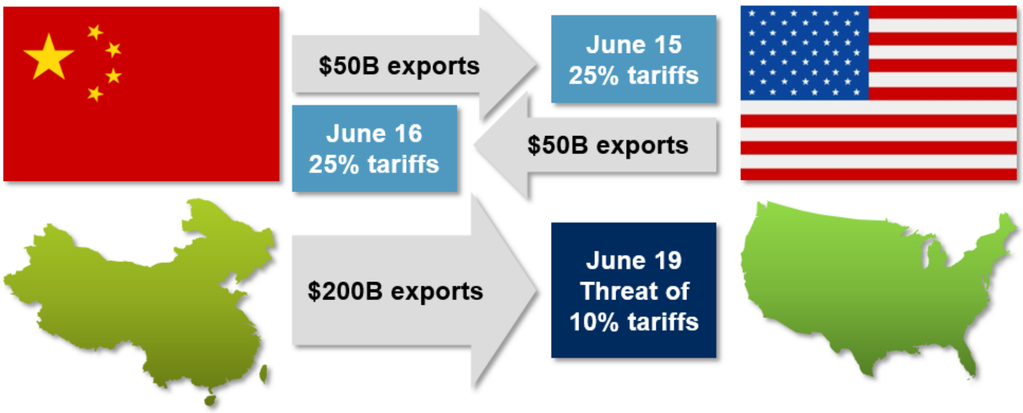
What's changed?

The Trump Administration has drawn the U.S. and China halfway to an all-out trade war, in S&P Global Ratings' view, with its recent announcement that the U.S. may impose tariffs on another $200 billion of unspecified Chinese imports—following moves in which each country will impose 25% tariffs on $34 billion of imports from one another starting July 6, and threatening to impose similar levies on another $16 billion of goods. Elsewhere, the administration has sharpened its rhetoric about what it sees as unfair trade practices from a number of U.S. allies—notably, the other members of the G-7.

Assessment of key risks

Beyond the possibility of a full-blown trade war with China and increased tensions with the U.S.'s other largest trade partners, we see the biggest risks to North American credit conditions as rising corporate debt, increased borrowing costs, and imbalances in Canada's housing market.

China-U.S. Trade Dispute: Tit-For-Tat Tariffs



Source: S&P Global Ratings

Trade: After President Trump's most recent directive to the USTR, China's Commerce Ministry released a statement warning that it may respond by "adopting comprehensive measures combining quantity and quality." While unclear what those measures might be, there are a number of ways outside of tariffs that China could hit back, such as delaying American goods from entering the country or curbing American investment in the world's second-largest—and still fast-growing—economy.

There's also precedent of the Chinese government's discouraging of citizens to buy foreign goods, as happened when sales of Japanese cars tumbled in late-2012 when the countries were engaged in a territorial dispute and again last year during China's unofficial campaign against South Korean consumer goods.

Meanwhile, China's first set of tariffs against the U.S. are skewed toward agricultural products and automobiles. This could have a significant effect on the U.S. farming sector—particularly in states that make up a significant portion of Mr. Trump's voter base—because China is the largest destination for American agricultural exports.

On another front, with formal trade talks between the European Union and Washington having broken down, the 28-member economic bloc responded to the White House's measures on steel and aluminum by imposing tariffs on $3.2 billion of American products made in Republican-leaning states, including bourbon, motorcycles and orange juice.

Trade officials renegotiating the North American Free Trade Agreement (NAFTA) have yet to reach a breakthrough, and the chance of an agreement this year has declined amid looming elections (a July presidential vote in Mexico and the U.S. midterms in November). In addition, the U.S. could add to the uncertainty by abandoning a multilateral treaty in favor of more complex bilateral agreements. Terminating NAFTA could lead to increased input costs, reduced competitiveness, and lower investment, and poses risks to the North America manufacturing supply chain.

Debt: As declining credit quality heightens borrowers' sensitivity to rising borrowing costs, U.S. nonfinancial corporate debt has reached a new high of $9 trillion, or 45% as a share of GDP and $14 trillion, or 73.5% of GDP, including borrowing by nonfinancial unincorporated businesses. The pickup in leveraged lending and speculative-grade bond issuance could amplify credit stresses if investors become more risk-averse, eroding borrowers' market access.

Interest Rates: Though the Federal Reserve has been measured in its tightening of monetary policy so far—and financial markets' response has been equally subdued—borrowers will at some point face higher rates and a potential funding-liquidity squeeze. This has yet to happen in earnest, but yields on corporate bonds have increased slightly of late, and we believe this gradual upward trend will persist, resulting in higher costs for corporate borrowers by year-end.

Canada Housing: With elevated prices squeezing home affordability and Canadian households holding a record C$2.1 trillion in credit market debt, housing market imbalances remain a key vulnerability for the country's economy.

Financing conditions

(Editor's Note: The following views are those of S&P Global Fixed Income Research. While these views can help to inform the rating process, sovereign and other ratings are based on the decisions of ratings committees, exercising their analytical judgment in accordance with publicly available ratings criteria.)

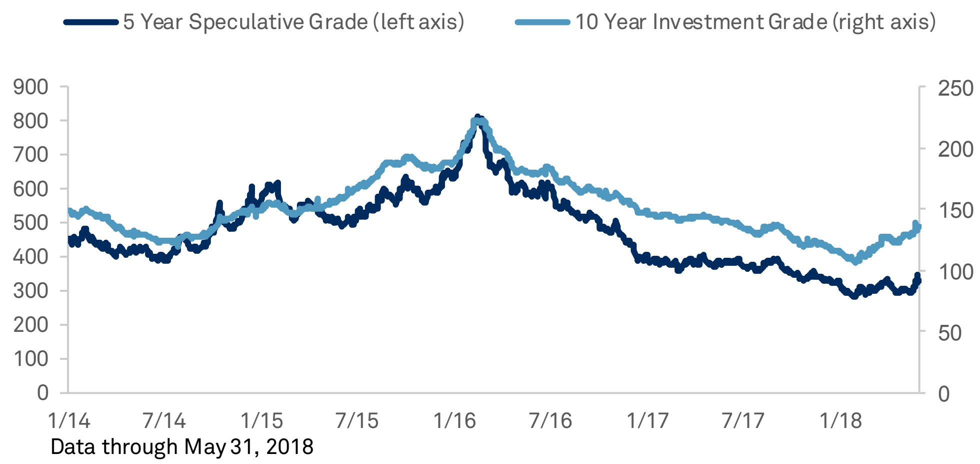
Conditions remain favorable halfway through 2018, with debt issuance holding up fairly well, the corporate distress ratio at the lowest in more than three years, upcoming maturities seeming manageable, and interest rates rising at a measured pace.

The Fed raised its benchmark rate in June, to 1.75%-2.0%—the second such move since Chairman Jerome Powell took the helm in February and the seventh since the central bank began tightening monetary policy in December 2015. Though the Fed has pursued a predictable path thus far, with little impact on financial markets, at some point higher rates will affect borrowers.

This may already be happening, as corporate bonds yields have crept up. We believe this gradual rise will persist, resulting in higher costs for corporate borrowers by year-end. That said, the spread on five-year spec-grade bonds finished May at 332 basis points (bps), little changed from 328 bps at the end of last year (see Chart 1). And while 10-year investment-grade spreads have widened 20 bps since the end of last year, to 136 bps, they're still near multiyear lows.

Chart 1

Investment-Grade and Speculative-Grade Corporate Bond Spreads (bps)



Source: S&P Global Fixed Income Research

Investors have favored floating-rate debt in recent months. Leveraged-loan issuance remains robust, and spreads are at lows not seen since July 2007. Moreover, the years-long trend of easy borrowing terms continues in this asset class, with more than three-fourths of deals in May classified as covenant-lite (that is, they lack the usual protecting for lenders).

Meanwhile, the distress ratio (the share of spec-grade issues with option-adjusted composite spreads of 1,000 bps or more over Treasuries) fell for the sixth straight month in May, to 5.2%—the lowest since January 2015. The retail and restaurants sector continues to have the highest ratio, at near 16%, followed by telecommunications at 13%. The latter accounts for the largest volume of distressed debt (at $12.8 billion) and had the steepest month-over-month decline, contributing to the overall falling distress level.

While U.S. corporate bond issuance fell to $111.7 billion in April, from $139.2 billion in March, this was still the highest April total in three years, dwarfing 2017's $82.3 billion, and helping to narrow the gap between year-to-date 2018 and 2017 totals (to -8.4%).

Both investment-grade and spec-grade corporate issuance increased in January-April (see chart 2). The former reached $353.7 billion, one of the highest totals in recent years but up against a tough comparison to 2017's $375.8 billion.

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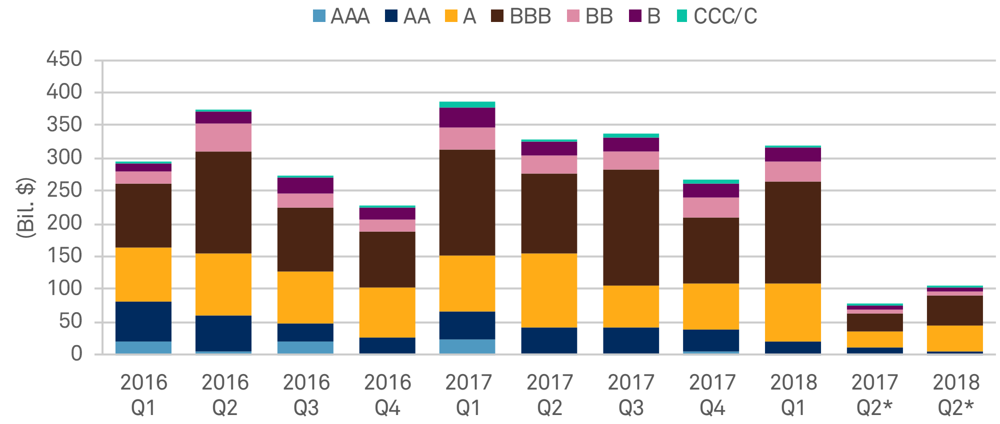
Chart 2

Quarterly Rated U.S. Corporate Bond Issuance



*through April 30

Sources: Thomson Financial and S&P Global Fixed Income Research.

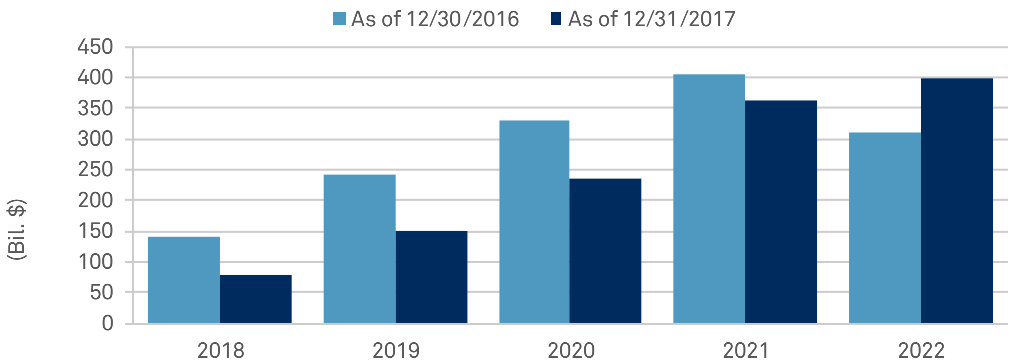
Spec-grade issuance fell to $16 billion in April, from $20.9 billion in March—but still bested the $12.9 billion in April 2017. Higher Treasury yields may be filtering through, eating away at demand. Through April, $69.6 billion came to market—much lower than the $85.6 billion last year and one of the weakest totals since the financial crisis. If investor skittishness about rising rates and trade turbulence increase, a flight to safety could mean the end of a bull run for spec-grade issuance.

As benchmark interest rates return to more normal levels and lenders regain stronger footing, funding liquidity could become tighter, and lower-rated borrowers would almost certainly find it harder to issue new debt. That said, it's too early to factor this into our base assumptions, and we believe U.S. corporate borrowers are well ahead of their maturing debt in the near-term.

Borrowers we rate have $4.4 trillion in debt coming due through 2022, with maturities rising to a peak of $1.04 trillion in the final year of that period. About 28% of the total is spec-grade nonfinancial debt—which is naturally more susceptible to refinancing risk (see Chart 3).

Chart 3

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. Foreign currencies are converted to USD on the respective report period date.

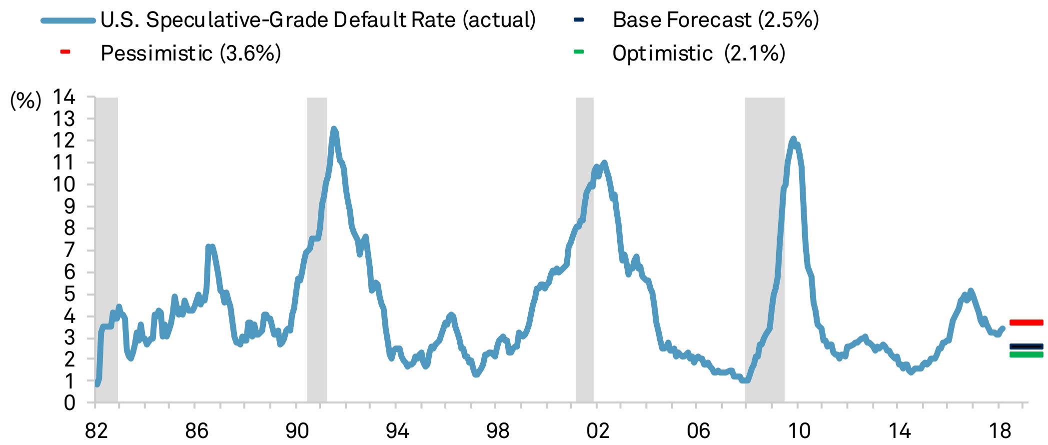
Source: S&P Global Fixed Income Research

Nonetheless, of the debt scheduled to mature this year and next, more than $151 billion was repaid, refunded, or retired last year. At the start of the year, $78.2 billion spec-grade nonfinancial debt was set to mature in 2018; halfway through the year, only $34.5 billion remains (with nearly half that in the 'BB' category).

S&P Global Fixed Income Research forecasts the U.S. trailing 12-month spec-grade default rate will fall to 2.5% by March 31, 2019, from 3.4% in March of this year (see chart 4, and "Despite Recent Volatility, The U.S. Speculative-Grade Corporate Default Rate Is Expected To Fall To 2.5% By March 2019 As Favorable Financing Conditions Persist," published May 22 on RatingsDirect). However, risks remain in the longer-term, including tighter monetary policy, a new tax code containing debt-deterring 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.

Chart 4

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



Shaded areas are periods of recession as defined by the National Bureau of Economic Research (NBER)
Sources: S&P Global Fixed Income Research and S&P Global Market Intelligence's CreditPro®

All of this is happening as corporate credit quality at the lower end of the scale is declining. About 24% of the spec-grade corporate issuers in the U.S. are rated 'B-' or lower, up from about 16% four years ago. This portion of the spec-grade universe has been growing steadily and is now at a high last seen during the financial crisis.

Macroeconomic developments and assumptions

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U.S.

State of Play: U.S. economic momentum remains strong, and S&P Global Ratings expects the world's biggest economy to grow above-trend this year and next—at 3.0% and 2.5%, respectively. Fundamentals underpinning this view include the strong labor market, bullish consumer confidence, and favorable manufacturing sentiment.

With headline unemployment at an 18-year low of 3.8%, consumer confidence is near a 17-year high, and core retail sales rose for a fifth straight month in May. The Institute for Supply Management manufacturing index also rose 1.4 points to 58.7, with all components above the "neutral" rate of 50—good news for new orders, shipments and employment.

Outlook: The healthy data point to a blockbuster GDP figure for the second quarter, which we expect to show an annualized expansion of 3.9%, as households and businesses spend some of their windfall from recent tax cuts. But we don't expect that this near-term boost will have legs, and forecast U.S. GDP growth to slow to its long-run potential of 1.8% by 2020.

Risks: The direct effects of the U.S.-China tariffs placed so far won't materially change the macroeconomic backdrop for the world's largest economy or overall corporate credit health within it; rather, they will likely boost consumer-price inflation only marginally and weigh a bit on already-sluggish U.S. productivity growth in the longer run. More importantly, the escalation of trade tensions between the two biggest economies of the world, and investment restrictions being considered by US Treasury could have broader real-world ramifications and sow the seeds of a noteworthy global growth slow-down.

We place the odds of a recession in the next 12 months at 10%-15%—with the risk of a trade war pushing it closer to the higher end of that range. And given the current state of the business cycle with the economy at near or at full employment, there is limited room for demand-led cyclical expansion. The prevalence of late-cycle conditions doesn't mean that the economy is guaranteed to tip into recession in the short-term, but such a risk is intensified barring supply-side pick-up (such as productivity growth)—and a financial shock (e.g., a sudden bear market in stocks, housing slump, or oil price spike) could be enough to tip the scales.

Canada

State of Play: Although the economic tailwind from firmer commodity prices is fading, Canada remains positioned for growth amid a revival in business spending, the lowest unemployment rate in four decades (5.8%), and steadily improving consumer sentiment. We see real GDP increasing 2.1%, on average this year and next, a pace that would be slightly ahead of Canadian potential output growth (1.5-2.0%), but below last year's 3%.

The Bank of Canada (BoC) policy rate stands at 1.25% after three quarter-point hikes since mid-2017. In that time, the effective interest rate that financial institutions charge customers for consumer credit, residential mortgages, and other loans has increased 66 bps to 3.43%. This is still well below the average 6% rate borrowers were paying in the decade before the financial crisis. Meanwhile, consumers' debt-servicing capacity is getting a lift from real wage gains in the range of 1.0-1.5% since the middle of last year, up from zero in the 12 months before then.

Outlook: Net exports could contribute more to real GDP gains this year and next, as the benefits from U.S. tax cuts boost spending for Canada's largest trading partner. Canadian exports are holding up relatively well despite the pickup in global trade tensions, as is business sentiment even while companies remain uncertain about the potential for protectionist trade measures and retaliatory tariffs to undermine trade and investment flows. Import growth, in part related to higher equipment spending by Canadian businesses, could lift lagging productivity growth above its long-term trend rate of 1%, as well as keep a lid on inflationary pressures and allow the economy to sustain growth above 2%.

Core inflation near the BoC's 2% target for CPI means the central bank will continue to raise its policy rate, likely to 1.75% by the end of this year, and to 2.5% in 2019.

Risks: Although increases in borrowing costs have been relatively mild so far, elevated price-to-income multiples are squeezing home affordability. With households having accumulated a record C$2.1 trillion in credit market debt, housing imbalances remain a key vulnerability for Canada's economy. The NAFTA renegotiation and potential contagion from global trade tensions are similarly a risk for Canada's trade-oriented growth prospects.

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- The near-term effects of recently imposed and planned tariffs will likely be minimal, but certain sectors will see some impact.
- M&A and financial policy is driving leverage risk. We see credit quality concerns from loosening credit terms and conditions as outstanding debt now exceeds $6.3 trillion.

What's changed?

The U.S. and China have been going tit-for-tat, with each imposing 25% tariffs on $34 billion of imports from each other, and threatening to impose similar levies on another $16 billion of goods. In short, trade tensions have ratcheted up to peak levels. The recent moves by the U.S. are generally aimed at industrial sectors that coincide with the "Made in China 2025" policy, which lays out a strategy for the country to dominate high-tech industries, while China's include tariffs on farm goods, automobiles, and seafood products. This could have a significant effect on the U.S. farming sector because China is the largest destination for American agricultural exports.

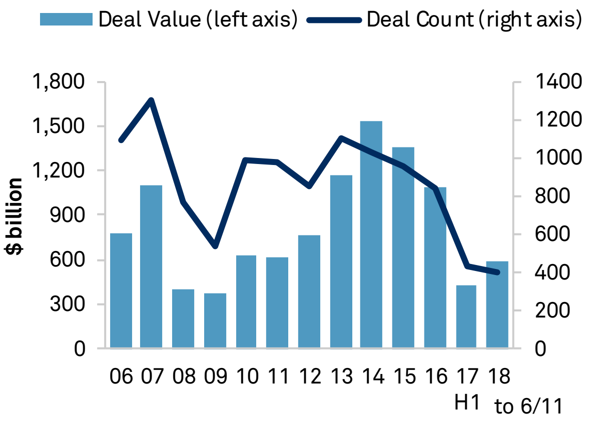
The U.S. also launched national security investigations on auto and auto parts imports, which could lead to 25% levies on them. NAFTA negotiators have so far failed to reach a breakthrough, and the U.S. ended exemptions on steel and aluminum tariffs for its NAFTA partners and the EU. Regardless, it is our belief that the potential near-term effects of these tariffs on corporate credit will likely be muted. The greater threat is that the dispute could expand beyond tariffs on goods.

Closer to home, corporate M&A and share buybacks have increased (see charts 5 and 6). M&A reached almost $600 billion in the first half of the year, sparked by the return of mega-deals and increased leveraged buyouts. Buybacks rose to $500 billion in the last 12 months.

We lowered our sector outlook to negative for consumer non-durables—with organic top-line growth continuing to be soft. We expect margins to be flat to down slightly for the sector. In addition, we've seen companies rated 'B-' and below having to refinance under less favorable pricing conditions.

Chart 5

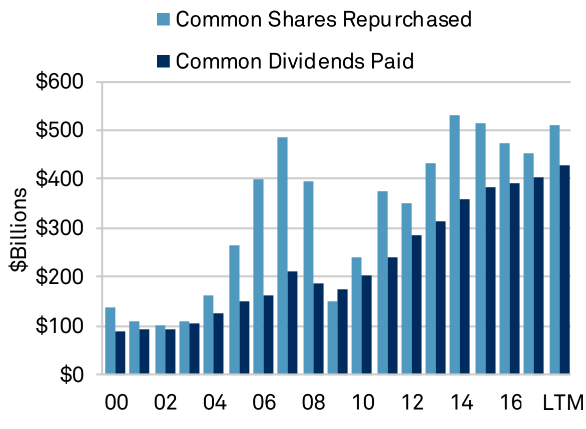
U.S. Corporate M&A--Announced deals with U.S. targets



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

Chart 6

Share Buybacks and Dividends



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

Key assumptions

We assume the U.S. economy will continue to expand, and financing conditions, including underlying terms and conditions, will remain broadly accommodative, with gradually rising borrowing costs.

Key risks

The main macro risks confronting corporate borrowers are the path of interest rates, financial market volatility/asset repricing, and the effects of ongoing trade tensions.

U.S. import tariffs will lead to higher input costs, some of which will be mitigated by the availability of substitutes or by companies' passing on the higher costs to consumers. The effects of tariffs that China (and other countries) will impose on American products--such as agriculture, capital goods, and autos--will be mostly negative but varied. Still, tariffs on agricultural products could end up hurting farmers more than our rated agricultural companies.

Tariffs are only one aspect of trade frictions--another being restrictions on foreign investment. Cross-border M&A--particularly in the technology sector, which is at the center of complaints of unfair trade practice and intellectual property theft against China--are vulnerable to an escalation in tensions. Disruption to supply chains is also a risk, with the North American auto and auto parts supply chain a main concern, given the NAFTA renegotiations.

With the credit cycle in an advanced phase, a downturn is nearer rather than farther, although we don't expect one to occur in the near term. Leverage risk--driven by M&A and financial policy--is also worth watching. Since the financial crisis, supply-demand imbalances arising from the long period of low interest rates have resulted in the universe of lower-rated credits expanding, with lurking risks embedded due to weak credit terms and conditions. The share of ‘BBB’ issuers in the ratings universe has also risen significantly--almost 200% since 2005. This could lead to a significant amount of spec-grade debt should economic headwinds materialize and downgrades result. The prospects of "fallen angel" (formerly investment-grade) credits competing against prevailing spec-grade borrowers for funding could ultimately result in higher financing costs for lower-quality borrowers, as secondary-market debt competes against new financing.

Recently passed tax reform has led to changes in financial policies by large issuers. Total U.S. non-financial cash and investments continued to grow and reached $2.1 trillion in 2017. We expect cash balances to decline for the first time in 2018 as cash-rich issuers return excess liquidity to shareholders and “right-size” their balance sheets. However, declining liquidity coupled with record amount of corporate debt, now at $6.3 trillion, should concern investors as we enter the late innings of a credit cycle.

Corporates continue to push out their maturities, with the peak in rated debt coming due in 2022. There are some notable exceptions. The oil and gas sector's maturities increase significantly in 2019-202--but absent another meaningful price decline, refinancing should be manageable (at currently higher oil prices). Downstream metals producers, such as steel companies, face large maturities in 2019 and 2021. Given the widespread challenges for certain retail segments, we are concerned with refinancing risk for mid-to low-spec-grade companies in 2018-2020 in these areas.

What to look for over the next quarter

The credit cycle is mature, with corporate borrowers carrying record amounts of debt and leverage. But low financing costs generally support debt-service coverage. We expect corporate profits to remain fairly strong, albeit facing cost pressure from wage and commodity inputs. And the corporate tax rate cut is boosting cash flows, which helps to extend the credit cycle. The outlook bias suggests a continuation of rating stability overall, with downgrade potential highest in retail and telecom.

The recent increase in oil prices has been manageable, but a spike could lead to a shock in consumption and confidence. Continued dollar strengthening would hurt profits of U.S. exporters and multinationals, weigh on commodity prices that are usually inversely related to the dollar, and could lead to deepening in emerging markets' problems.

Policy uncertainty will continue to drive credit conditions in the next quarter. We will monitor if trade disputes escalate further and begin to have larger impacts on corporate issuers, and see how the July Mexican presidential election and ramping up toward U.S. midterms could affect NAFTA renegotiation prospects.

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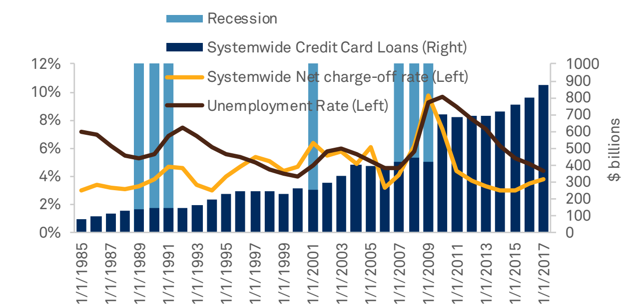
- U.S. and Canadian banks are benefitting from rising interest rates, loan growth (as GDP grows), and tax cuts.
- The U.S. legislative changes don't immediately affect the BICRA/ratings of U.S. banks.
- Areas to watch for emerging risks include U.S. auto loans, credit cards, commercial real estate (CRE), and leveraged lending (see charts 7 and 8).
- For Canadian banks, we expect a "soft-landing" in the housing market, likely helped by policy tightening that took effect this calendar year.

What's changed?

Our sector outlook is largely similar. Among U.S. banks, there have been six positive rating actions (two due to similar actions on a foreign parent), and only one negative action in the second quarter. For Canadian banks, there were no significant ratings actions, as final regulations for senior bank "bail-in" debt were issued.

Chart 7

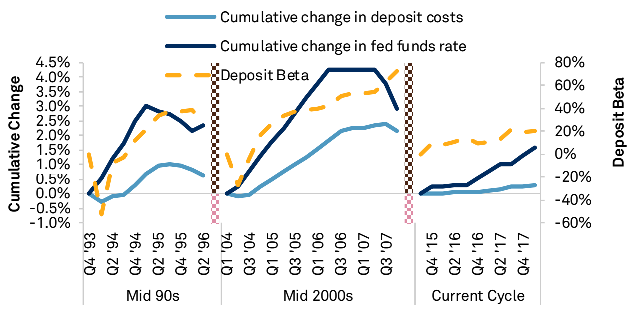
Credit-card loss rate vs. unemployment rate (US)



Source: S&P Global Ratings

Chart 8

Deposit betas may begin to rise more significantly



Source: S&P Global Ratings

Key assumptions

We expect interest rates to increase gradually and GDP growth in both the U.S. and Canada to remain solid—with no major disruption related to the NAFTA renegotiations. Loan growth looks likely to continue, roughly in line with nominal economic expansion. Credit losses seem to have bottomed out and will gradually increase starting next year.

Key risks

- Among the risks to the sector are rising rates and the effects on market valuations and asset quality.
- Deposit betas could rise farther or more quickly than current ratings assume (implying more interest-rate risk for liability-sensitive banks).
- A messy NAFTA renegotiation could undermine banking customers' confidence and related business flows—which we see as more important for Canadian than U.S. banks.

Insurance

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– At mid-year, the financial strength of North American insurers remains generally strong, with broadly stable rating outlooks conveying S&P Global Ratings' expectation for limited ratings changes in the next 12 months.

What's changed?

Ratings activity in the second quarter has been affirmation-oriented, with some modest net upward movement. Overall, the average financial strength rating for the portfolio is at the upper end of the strong 'A' category (see table 2).

Table 2

Sector	Average credit quality (financial strength rating)	% of ratings with stable outlook
Life	A+	80%
Health	A	70%
Property / Casualty	A	77%
Global Reinsurers	A+	77%
Bond Insurers	AA	100%
Title Insurers	A	66%
Mortgage Insurers	BBB	50%

Source: S&P Global Ratings.

Key assumptions

Balance-sheet strength remains a pillar of credit-quality support for the portfolio, providing a measure of protection from risks related to downside economic development broadly, and the expansion or increase in the magnitude of current subsector challenges more specifically.

Key risks

Factors related to pricing, profitability, growth, M&A, and regulation/legislation continue as areas of concern and analytical focus.

What to look for over the next quarter

The Life sector is seeing slow growth with pockets of opportunity. Outside of retail products, we expect pension-risk transfers to be a growth area for insurers willing and able to manage the related risks. We also expect an active M&A environment in the near term, supported by nontraditional buyers, legacy books for sale, and some insurers' desire for scale.

The Health sector is undergoing improving profitability, re-emergent deal risk (underscored by two very large cross-sector deals, CVS-Aetna and Cigna-Express Scripts) and lingering legislative and policy uncertainty relative to the Affordable Care Act (ACA) in general and the individual (under-65) product segment in particular.

The Property/Casualty sector is showing resilience in the wake of recent natural catastrophes. After a prolonged period of pricing complacency leading to rate inadequacy in many product lines, something is likely to give. Even though we expect pricing to improve, our combined-ratio forecast near 100% implies a weak pricing correction. For global reinsurers, pricing is at an inflection point (with pricing up about 5% following 2017 events), but our concern is sustainability.

The Bond Insurer sector is benefiting from rising interest rates and growing retail demand. With credit spreads likely to widen with the rise in interest rates, we expect bond insurers to experience better pricing and growth opportunities as the economics of bond insurers are more appealing to investors and issuers. The limits on tax deductions could create greater retail demand in high-tax states for municipal bonds and bond insurance, as recent headline events relating to municipal issuer stress highlighted the benefits of bond insurance.

For **Mortgage Insurers**, rising interest rates have led to a shift in business mix for private mortgage insurers (PMI) to purchase transactions. Notwithstanding the supply squeeze and rising mortgage rates, PMIs continue to benefit from favorable trends in employment and housing, as well as growing income levels in many markets, which has led to house-buying power for homebuyers.

Structured Finance

- Credit remains largely stable, with defaults and delinquencies largely in check.
- Signs of maturing cycles are emerging for collateralized loan obligations (CLOs), commercial mortgage-backed securities (CMBS), and subprime auto loans.

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What's changed?

The current performance of, and the outlook for, structured finance remains largely stable, underpinned by continued moderate economic growth, declining unemployment, and relatively low interest rates. Defaults and delinquencies remain largely in check across the board.

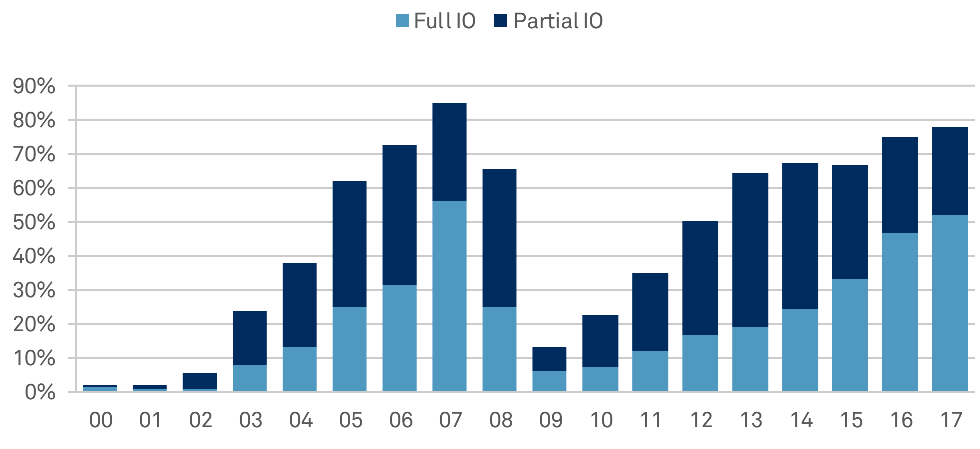
What to look for over the next quarter

There are several instances of "late-cycle" behavior that we are monitoring across multiple sectors. On the CLO side, where issuance continues to be very active, we are closely monitoring weakening trends in documentation. On the asset (that is, underlying leveraged loans) side, we believe the proliferation of covenant-lite lending has, all else equal, lowered recovery prospects. On the liability side, we continue to see more equity-friendly provisions working themselves into transactions (see "Par Wars: The Investor Strikes Back," published May 2).

On the CMBS side, interest-only loan concentrations have returned to near 2006-2007 (peak issuance years) levels. Loans with an interest-only (IO) period tended to default at about 1.5 times the rate of amortizing loans, but full-term IOs, which tend to be located in primary locations and have lower leverage, had lower loss severities (see chart 9). We continue to monitor this trend, as property-price appreciation and low rates may have lifted performance of full-term IOs during the previous cycle (as they did with other types of loans).

Chart 9

IO Share of Vintage (2000-2018 YTD)



Source: S&P Global Ratings

Further, we also note some weakening in CMBS loan-documentation standards and wider variation in creditworthiness—although overall leverage appears in check.

On the subprime-auto side, we've observed that since the mid-1990s, about every 10 years the sector and related asset-backed securities (ABS) market has experienced a growth phase followed by a contractionary period. There are some signs of another period of consolidation emerging.

In total, approximately $141 million worth of bonds have been sold so far this year in 'B' rated subprime auto loan ABS notes (at time of issuance) compared to *zero* in 2017 (see table 3). This is reminiscent of the mid-1990s, when 'BB' rated classes first become popular. Auto-related ABS volume carrying 'BB' ratings grew from $5.2 million in 1995 to $26.2 million in 1996 and approximately $60 million in 1997 just as the subprime auto-loan industry was beginning to unravel.

Table 3

'B' Rated Subprime Auto Loan ABS Issuance in 2018

Transaction	Amount (US$ Millions)
WLAKE 2018-1 Class F	56.71
WLAKE 2018-2 Class F	56.68
UACST 2018-1 Class F	6.07
ACAR 2018-1 Class F	14.0
FIAOT 2018-1 Class F	7.53
Total	140.99

Source: Bloomberg, S&P Global Ratings.

The reasons for today's growth in single 'B' rated securities mirrors the reasons 'BB' rated securities became popular in the mid-1990s:

- the maturation of the subprime auto loan ABS market;
- wider acceptance of spec-grade ratings in the ABS market, fueled by investor demand for higher yield; and
- the growth in the number of subprime independent auto-finance companies using the securitization market as their primary funding source and their desire to maximize proceeds from bond issuance.

While the subprime auto-loan ABS market has experienced positive rating movements, with approximately 1,100 upgrades year-to-date from 2004, and no downgrades, it's important to remember that spec-grade classes are subject to greater ratings volatility than investment-grade, and there is no history on how single 'B' rated subprime auto loan classes have performed through prior economic or business downturns. Certainly, as the number of 'BB' and 'B' rated classes grows, we would expect ratings performance to become more volatile than it has been.

Public Finance

- State fiscal conditions have improved as a result of stronger-than-anticipated revenues and a slowdown in new Medicaid enrollments.
- Local governments' credit quality has been stable, but policy changes at the federal level—including the Tax Cuts and Jobs Act (TCJA) and tariff adjustments—may pose longer-term challenges

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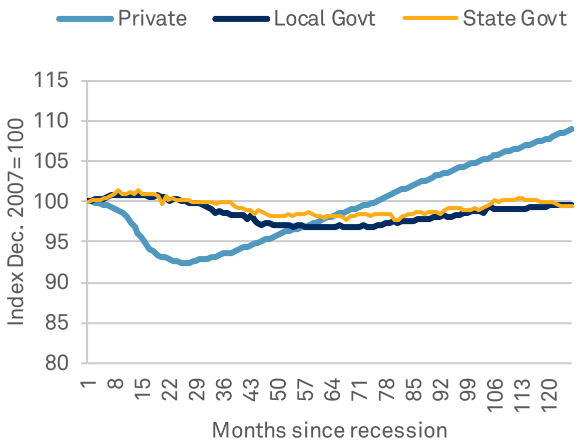
What's changed?

For states, strong revenue gains—above most state forecasts—that emerged early in the year appear to have lasted through April. Relative to their forecasts, the positive revenue variance has eased fiscal conditions and points to near-term credit stability across the sector.

When state government performance is strong, local governments generally benefit through state support for schools, revenue sharing, etc. When combined with healthy economic growth and falling unemployment rates, it bodes well for continued stability in the local government sector (see charts 10 and 11).

Chart 10

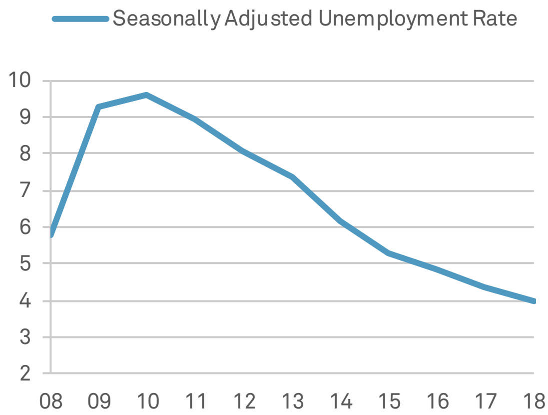
Payroll trends since recession



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

Chart 11

Seasonally Adjusted Unemployment Rate (%)



Source: U.S. Bureau of Labor Statistics, S&P Global Ratings

Key assumptions

- We expect continued broad-based economic expansion with steady job growth of slightly less than 200,000 new payroll positions per month.
- As states finalize and enact their budgets for fiscal 2019, political rancor may subside.
- Steady economic growth and low unemployment will help support credit quality.

Key risks

A sharp decline in consumer confidence leading to a selloff in equity markets could undermine state revenue trends, most of which are built upon the assumption of continued gradual market appreciation. Inexorable upward pressure on mandatory expenditures for Medicaid, pension contributions, and retiree health benefits costs is likely to outpace states' recurring revenues. Thus, a recession isn't necessary for states to suffer renewed fiscal stress. Structural pressures have constrained state spending in operating budgets as indicated by hiring; states have replaced only 47% of payroll positions they cut during the recession.

For local governments, adjusting to policy changes from the federal government could create challenges. Most notably the TCJA and ongoing tariff conversations are likely to have an impact on some, but not all, credits. The uneven distribution of these effects will be felt most by borrowers already struggling to sustain budgetary balance in the face of rising pension costs and a backlog of infrastructure needs. In addition, should there be localized negative economic effects from policy changes, it would exacerbate any emerging structural deficits.

What to look for over the next quarter

Whether final enacted state budgets for fiscal 2019 achieve structural balance with sufficient recurring revenues to support ongoing spending commitments is a key leading indicator of state fiscal health.

We expect it will take some time for impacts from the TCJA to appear at the local level, so the likelihood of credit implications over the next three months is minimal. However, if and when final determinations on tariff changes are decided—and carried out—it could have a more immediate impact for export-heavy communities, as well as local economies centered on manufactured goods using newly tariffed raw materials. The impact would be felt most acutely in areas with limited economic diversity.

Related Research

- Global Trade At A Crossroads: U.S. Quadruples Down In China Dispute, Sparking Wider Fears Of An All-Out Trade War, June 19, 2018
- Global Trade At A Crossroads: The Risk Of An All-Out China-U.S. Trade War Moves Up A Notch, June 18, 2018
- Global Issuance And Financing Conditions: Bond Issuance Is Up 1% Through April On Strong Chinese Totals, June 8, 2018
- Research Update: United States 'AA+/A-1+' Ratings Affirmed; Outlook Remains Stable, June 26, 2018
- The U.S. Speculative-Grade Corporate Default Rate Could Fall To 2.5% By March 2019 As Favorable Financing Conditions Persist, May 22, 2018

Only a rating committee may determine a rating action and this report does not constitute a rating action.

Appendix: Ratings trends and surveys

North America Banking Industry Trends

U.S.	BICRA Group 3/10	Canada	BICRA Group 2/10
Economic Risk Factors	**Industry Risk Factors**	**Economic Risk Factors**	**Industry Risk Factors**
Score **3**	Score **3**	Score **3**	Score **2**
Trend **Stable**	Trend **Stable**	Trend **Stable**	Trend **Stable**

Note: Our BICRA Groups, Economic risk scores, and Industry risk scores are each classified '1' through '10', from lowest- to highest-risk. Economic and Industry risk trend are each classified as stable, positive or negative. For more information please see Banking Industry Country Risk Assessment Update: June 2018

North America Nonbank Financial Trends

Negative	Stable to Negative	Stable	Stable to Positive	Positive
	Finance companies	Asset managers		

Note: Sector outlook indicates credit rating trends expected over the coming 12 months. Stable to Positive (Stable to Negative) outlook indicates potential for a modest number of rated entities in the sector to be upgraded (downgraded). Positive (Negative) outlook indicates potential for a material number of rated entities in the sector to be upgraded (downgraded). Arrows (if displayed) indicate direction of change in sector outlook from previous quarter.

Source: S&P Global Ratings

North America Corporate Sector Trends

U.S.

Negative	Stable to Negative	Stable	Stable to Positive	Positive
Healthcare services; Retail	Capital goods; Telecom; Media and entertainment	Aerospace and defense; Auto OEMs and Auto suppliers; Forest products; Leisure and sports; Pharma; Regulated utilities; REITs; Technology; Transportation; Oil refineries; Oil and gas; Unregulated (merchant) power; Chemicals	Homebuilders; Midstream energy; Metals and mining	
		Building materials		
	Consumer durables			
Consumer nondurables				

Canada

Negative	Stable to Negative	Stable	Stable to Positive	Positive
Media and entertainment; Unregulated (merchant) power	Midstream energy; Oil and gas	Forest products; Retail; Building Materials; Transportation (Canadian airlines); Transportation (Canadian rails); Utilities; Telecom; Chemicals	Metals and mining	

Note: Sector outlook indicates credit rating trends expected over the coming 12 months. Stable to Positive (Stable to Negative) outlook indicates potential for a modest number of rated entities in the sector to be upgraded (downgraded). Positive (Negative) outlook indicates potential for a material number of rated entities in the sector to be upgraded (downgraded). Arrows (if displayed) indicate direction of change in sector outlook from previous quarter.

Source: S&P Global Ratings

North America Insurance Trends

Negative	Stable to Negative	Stable	Stable to Positive	Positive
		Life Insurers; Property & casualty insurers; Title Insurance; Reinsurers; Bond insurers; Health insurers	Mortgage insurers	

Note: Sector outlook indicates credit rating trends expected over the coming 12 months. Stable to Positive (Stable to Negative) outlook indicates potential for a modest number of rated entities in the sector to be upgraded (downgraded). Positive (Negative) outlook indicates potential for a material number of rated entities in the sector to be upgraded (downgraded). Arrows (if displayed) indicate direction of change in sector outlook from previous quarter.

Source: S&P Global Ratings

U.S. Public Finance Trends

Negative	Stable to Negative	Stable	Stable to Positive	Positive
		Local governments; States; Health care; Higher education; Housing; Electric utilities; Garvees; Water and sewer utilities; Airports and ports		Toll roads and bridges

Note: Sector outlook indicates credit rating trends expected over the coming 12 months. Stable to Positive (Stable to Negative) outlook indicates potential for a modest number of rated entities in the sector to be upgraded (downgraded). Positive (Negative) outlook indicates potential for a material number of rated entities in the sector to be upgraded (downgraded). Arrows (if displayed) indicate direction of change in sector outlook from previous quarter.

Source: S&P Global Ratings

North America Structured Finance Trends

Residential mortgages

Negative	Stable to Negative	Stable	Stable to Positive	Positive
		RMBS - Servicer advance ; RMBS Re-REMICS	RMBS	

Commercial mortgages

Negative	Stable to Negative	Stable	Stable to Positive	Positive
		CMBS - Canadian conduit/fusion; CMBS - large loan/single borrower	CMBS - U.S. conduit/fusion	

Asset-backed mortgages

Negative	Stable to Negative	Stable	Stable to Positive	Positive
		ABS - auto loans; ABS - auto lease; ABS - credit cards; ABS - unsecured consumer loans; ABS - FFELP student loan ; ABS - private student loan; ABS - commercial equipment; Asset-backed commercial paper		

Structured credit

Negative	Stable to Negative	Stable	Stable to Positive	Positive
	Tobacco	CLOs; Timeshares; Small business; Transportation		

Note: Sector outlook indicates credit rating trends expected over the coming 12 months. Stable to Positive (Stable to Negative) outlook indicates potential for a modest number of rated entities in the sector to be upgraded (downgraded). Positive (Negative) outlook indicates potential for a material number of rated entities in the sector to be upgraded (downgraded). Arrows (if displayed) indicate direction of change in sector outlook from previous quarter.

Source: S&P Global Ratings

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