S&P Global
Ratings

Credit Conditions North America:
Potholes On The Road To Recovery

Sept. 29, 2020

(Editor's Note: S&P Global Ratings' Credit Conditions Committees meet quarterly and on an ad hoc basis to review macroeconomic conditions in each of four regions (Asia-Pacific, Emerging Markets, North America, and Europe). Discussions center on 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 Sept. 23, 2020.)

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Key Takeaways

- **Overall:** While credit conditions are largely favorable for many borrowers, pockets of risk are rising—particularly for U.S. state and local governments, whose tumbling revenues are adding to budget pressures. Risks around commercial real estate, too, are growing.
- **Risks:** The threat of financial-market volatility has heightened as the U.S. election draws near—especially if the presidency is in dispute, as in 2000. Moreover, if Republicans and Democrats continue to split power in Washington, the chance for another round of sweeping fiscal stimulus may disappear.
- **Credit:** Yields on Treasuries and on private-sector debt have all fallen or remain low. Issuance is robust across the credit spectrum, with even the combined leveraged loan and speculative-grade bond offerings to date exceeding the same period last year.

As the U.S. economy begins what will almost surely be a long, hard road to recovery from its sharpest slump since World War II, credit conditions—facilitated by central bank monetary stimulus—are largely favorable for many borrowers.

Still, pockets of risk are growing. U.S. state and local governments are under budget pressures as revenues tumble, and the pain could intensify unless federal legislators agree on another round of stimulus—with a deal proving elusive. Premature austerity from Washington would draw out the timeframe for state and local governments to regain their fiscal balance, weighing on the U.S. economy (with states and locals accounting for about 11% of GDP). Many have already started slashing their budgets and will have to cut deeper without additional stimulus. This is crucial given that, in times of deep imbalances, governments often make choices that hurt their long-term credit stability, such as reducing pension contributions or deferring infrastructure investment.

Risks around commercial real estate, too, are growing amid a wave of bankruptcies among brick-and-mortar retailers, the coronavirus-related hit to lodging, and diminished demand for office space as more Americans work from home, at least some of the time (although the effects of the latter may be overstated given where we are in the course of the pandemic).

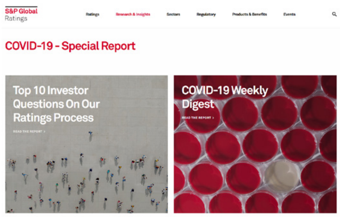
All of this comes as the Nov. 3 election in the U.S. draws near. With the presidency and 35 of 100 Senate seats (as well as all 435 House of Representatives seats) at stake, the risk of increased financial-market volatility is growing—especially if it isn't immediately clear who has won the White House, as in 2000. Moreover, if Republicans and Democrats continue to split power, the chance for another round of sweeping fiscal stimulus may disappear.

On the bright side, credit conditions for nonfinancial corporate borrowers are broadly favorable, and the wave of negative rating actions we saw early in the first months of the pandemic has slowed. Financing costs have decreased in the primary market, and spreads generally have tightened in secondary markets to roughly half what they were at the peak in late March.

S&P Global Ratings acknowledges a high degree of uncertainty about the evolution of the coronavirus pandemic. The current consensus among health experts is that COVID-19 will remain a threat until a vaccine or effective treatment becomes widely available, which could be around mid-2021. We are using this assumption in assessing the economic and credit implications associated with the pandemic (see our research here: www.spglobal.com/ratings). As the situation evolves, we will update our assumptions and estimates accordingly.

Links

Daily research updates, including a summary of related ratings actions, are available at:
https://www.spglobal.com/ratings/en/research-insights/topics/coronavirus-special-report



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And the U.S. economy has shown signs of resilience. Consumer spending has held up well, and the housing market is strong. Additionally, new COVID-19 outbreaks in parts of the country didn't curb economic activity as much as we expected (perhaps because of lockdown fatigue and policymakers' reluctance to mandate social-distancing measures). However, the recovery faces more challenges now that extended federal unemployment benefits have expired and job gains have waned.

Table 1

Top North America Risks

Coronavirus-related health crisis persists, affecting consumer behavior, exacerbating the economic shock

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

The U.S. economy is showing signs of a nascent recovery from the pandemic-induced shock, notwithstanding COVID-19 cases still growing in many states. However, short of a vaccine or effective treatment, which we assume won't be widely available until next year, there is a risk that a resurgence of the outbreak could lead states to extend, or restart, social restrictions and worsen the pain associated with historically high unemployment and severe business disruption. Consumers may also slowly return to old spending habits. Moreover, uncertainty around federal fiscal stimulus could weigh unevenly on states, the largest of which are important economic drivers for the country. Housing dislocations, as yet largely on hold, could also become a disruptive factor. Our base case sees GDP growth returning in the second half of the year. The risk that this won't materialize, and that the drag on consumer demand and business activity would persist, is firmly on the downside.

Historically high corporate debt threatens credit quality and could result in financial market dislocation

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

As corporate borrowers incur more debt to shore up liquidity and deal with coronavirus-related disruptions, high leverage and potential insolvency are increasingly concerns. While debt issuance has helped stave off near-term bankruptcies, especially for lower-rated issuers, companies will be saddled with a significant amount of higher-cost debt that may become unsustainable when facing years of lower revenues and earnings. Meanwhile, in another sign of the volatility around the shape of the recovery, the benchmark S&P 500 equity index has surged more than 50% from its March low, credit spreads in the secondary market have narrowed by about half from March's extreme highs, and U.S. debt issuance so far this year is 70% more than the year-to-date volume of last year. This sharp contrast with our expectation for a slow and uneven economic recovery that will weigh on corporate profits (and credit quality) suggests that a sudden return to "risk-off" positioning could spur market dislocation.

U.S.-China strategic confrontation disrupts trade and supply chains, hitting U.S. economic growth

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

As U.S.-China tensions intensify—with President Trump's executive order to ban some Chinese mobile apps, and the countries trading consulate closures—American companies and consumers continue to shoulder a significant burden of the dispute. Although the "Phase One" trade deal alleviated some pressures, the pandemic's economic toll on China means it won't likely be able to increase its purchases of American goods as much as the pact lays out. Moreover, the dispute over technology, intellectual property, and market access persists. As the U.S. election heats up, we will likely hear harsher criticism of China from both candidates.

U.S. election results roil financial markets, spur additional civil unrest

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

With the U.S. presidency and 35 of 100 Senate seats (as well as all 435 House seats) up for grabs on Nov. 3, the risk of increased financial-market volatility is growing—especially if the result of the run for the White House is in dispute, as in 2000. Moreover, if Republicans and Democrats continue to split power in Washington, the chance for another round of sweeping fiscal stimulus may disappear; this could weigh heavily on an economy struggling to recover from the pandemic-induced slump, fuel protests already gripping many American cities, and send markets reeling.

Low oil demand hurts Canada and the U.S.

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

COVID-19-induced demand shock coupled with better but still-depressed oil prices are casting a shadow over the U.S. and Canadian economies—both of which are net oil exporters. A slow recovery of global air traffic could further weigh on demand prospects. Not only will persistently low prices pressure credit quality of the upstream oil and gas industry and related sectors including midstream energy, it may also hurt economies and revenues of oil-producing provinces/states.

Cybersecurity threats to business activity

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

As the coronavirus pandemic forces almost all organizations—public and private—to accelerate their digital transformation, cyber-risks continue to pose a systemic threat and significant single-entity risk. As cyberattacks become more sophisticated, new targets and methods are emerging. The key to cyber-risk resilience is a combination of risk management actions—both pre- and post-attack—and swift remediation, which is increasingly vital as the nature of threats continues to evolve. Entities that don't have well-tested playbooks to shape their responses could become more exposed to future attacks. Meanwhile, commercial and private cyber insurance premiums now total about $5 billion, and we expect this to soon increase 20%-30% per year.

Source: 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.

Macroeconomic Outlook

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U.S.

The world's biggest economy has begun to rebound from the worst of the pandemic-induced recession. Federal fiscal stimulus has spurred consumer spending, which accounts for about 70% of the U.S.'s $21 trillion GDP, and the housing market is strong, as historically low interest rates entice buyers. Moreover, waves of new COVID-19 outbreaks in some states haven't hampered economic activity as much as we'd expected. That said, there are signs that activity will slow as the country transitions to autumn particularly as the U.S. enters flu season with no COVID-19 vaccine. And the recovery may face more hurdles now that extended federal unemployment benefits have expired and job gains have slowed.

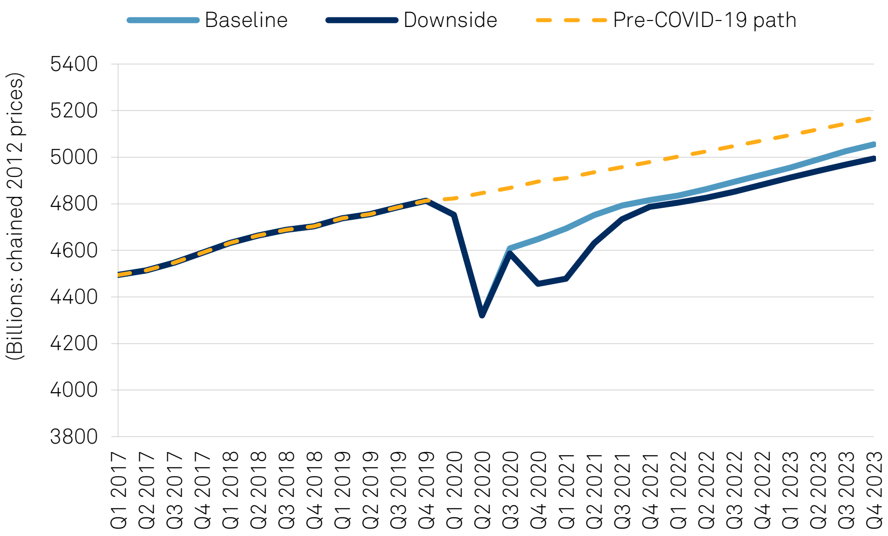
Consumer spending recovery has surprised on the upside since May, driven by pent-up demand and lower interest rates. However, consumers may become more reluctant to open their wallets as summer ends. Spending momentum cooled for a third straight month in August, with retail sales rising just 0.6% (and core sales slipping 0.1%). If Congress can't strike a deal to extend aid to American households in the coming weeks, the U.S. economy could be particularly susceptible to a cutback in consumer outlays—especially from the lowest-income families, who tend to spend a higher percentage of their incomes than wealthier individuals do.

Moreover, spending on services remains 10% below pre-crisis levels. Real-time data is indicating consumer demand is struggling to sustain upward momentum, with the expiration of fiscal aid and a still-uncertain health situation jeopardizing the main engine of growth.

S&P Global Ratings now expects U.S. GDP to grow an annualized 29.5% in the third quarter and contract 4% for full-year 2020—significantly better than the 5% we saw in our June forecast (see chart 1). But to put this into perspective, a 4% decline in the world's biggest economy is still historically bad, and the projected gain in July-September doesn't come close to making up for the worst-ever annualized 31.7% contraction in the second quarter.

Chart 1

Evolution Of U.S. Real GDP



Sources: Oxford Economics, BEA, and S&P Global Economics.

Job gains have slowed considerably since a surge in May, and initial jobless claims remain stubbornly high. The economy regained 1.37 million jobs in August, according to the Bureau of Labor Statistics, but only half of those lost in March-April have been recouped. There are still 11.6 million fewer jobs than before the pandemic. Meanwhile, the unemployment rate fell to 8.4% in August, a quicker-than-expected retracement from the 14.75% peak in April, but remains twice as high as in February, with 13.6 million people reporting that they are unemployed. Worse yet are signs that what was once considered temporary unemployment is becoming permanent, a structural shift that could lead to deep economic scars.

Damage from the wildfires in California and other Western states, and the storms that have hit the Gulf Coast may also deliver a significant blow to economic activity in those regions and weigh on third-quarter GDP growth. (Spending to fight wildfires will offset some of the economic hit.) Moreover, at least some of the economic losses related to natural disasters are recouped in subsequent quarters, as homes and business are rebuilt. But, while there's always some measure of activity in the rebuild, what was previously built is permanently lost.

With no coronavirus vaccine yet available as the U.S. heads into the colder months (and the height of flu season), a lack of new fiscal stimulus, and trade tensions with China on the rise, we see the risk that the U.S. will slip back into recession at 30%-35%, assuming that the National Bureau of Economic Research (NBER) says that the COVID-19 recession ended in May.

Canada

In contrast with the U.S., Canada's relatively widespread social-distancing measures meant a sharper decline in economic activity in the second quarter. The GDP pullback in April-June was the sharpest, going back to at least 1960 (the beginning of the data). Real GDP contracted roughly 11.5% (shrinking 39% annualized), translating to 13% below its year-earlier level.

Disciplined phased openings has also meant a relatively better performance in managing the virus in the third quarter. The economy has rebounded as expected, with substantial pent-up demand leading a rebound in retail sales, home resales, and housing starts that have surprised on the upside. Through August, the labor market regained about two-thirds of the 3 million jobs lost in March-April (compared to just half in the U.S.).

By the end of the third quarter, we believe the economy will have recouped a little more than three-fifths of the 13.4% peak-to-trough output lost in the first half. The government's new mix of income support measures for households (a transition from the Canada Emergency Response Benefit) will be about 20% less generous, but still offer enough to avoid cliffs in household spending in the coming quarters. This should translate into a contraction in real GDP of 5.6% this year on an annual average basis (was -5.9%) before expanding return to growth of 4.9% next year (was 5.4%).

Before the pandemic, Canada was already slowing down, with soft consumer spending, high household debt-to-income ratios, and labor disruptions. The sharp drop in energy prices just made things worse. Assuming any subsequent waves of infection aren't overwhelming, we continue to expect an economic recovery tested by several factors following a near-term bounce in aggregate demand and employment as lockdowns ease. Lingering scars in the form of virus fears, bankruptcies, and social distancing will limit capacity utilization and growth for one-third of the economy. The unusual nature of this service-centric shock makes the recovery more uncertain than usual. The path of the virus remains highly unpredictable, and the possibility of an economic stop-and-go with “false dawns” mean the risks to our baseline forecast are on the downside despite the central government's willingness to increase fiscal support.

We don't see real GDP regaining its pre-pandemic level until first-quarter 2022. We expect headline unemployment, after topping out at 13.7% in May, to come back down to a 9% monthly average by the fourth quarter of this year and 7.3% by the fourth quarter of next year. Unemployment won't likely get back under 6% (pre-pandemic level) before 2024. Inflation, as measured by the core Consumer Price Index (core-CPI), will likely get back to 2% sustainably only in 2023. Because of the high bar to tighten monetary policy in the next few years, we anticipate the Bank of Canada will keep the policy rate at the current 0.25% through 2023.

Financing Conditions

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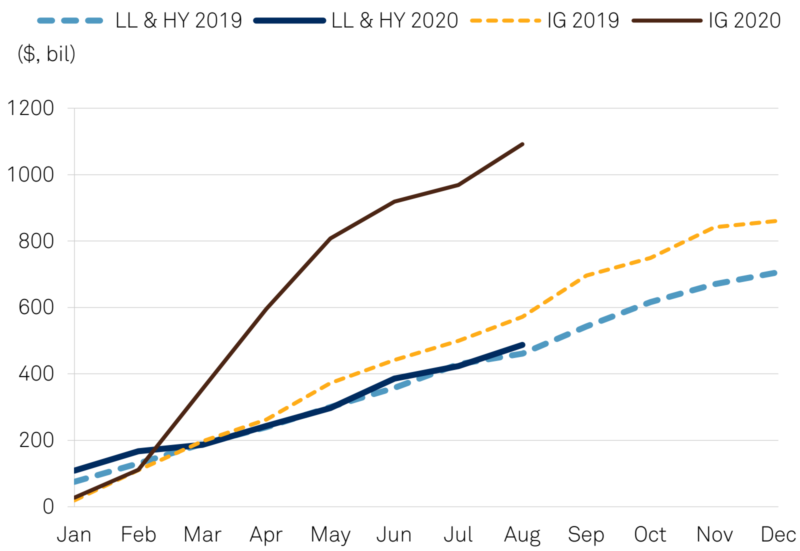
Through the summer, financing conditions generally improved for borrowers, adding to their historically quick turnaround in the second quarter. Yields on Treasuries and private sector debt have all fallen or remained low. Issuance remains robust across the credit spectrum, with even the combined leveraged loan and speculative-grade bond total exceeding last year's through August (see chart 2). Meanwhile, investment-grade issuance remains on track for breakthrough year.

Financial markets remain optimistic for now, as developments on the vaccine front are largely positive and the Federal Reserve's suggestion that it will keep its benchmark interest rate near zero for another three years supports favorable borrowing costs. In the near term—with a presidential election looming and control of the Senate difficult to predict—markets have so far been optimistic with only six weeks to go before the general election.

That said, some of the recent increased issuance could be a short-term "pull forward" ahead of a possible chaotic election in the U.S., which has a higher-than-usual chance of producing either no clear winner on election night, or a result that will be quickly challenged by the losing side. This would likely suppress typical November issuance, and could foster market volatility.

Chart 2

Corporate Issuers Continue To Find Ample Demand For New Debt



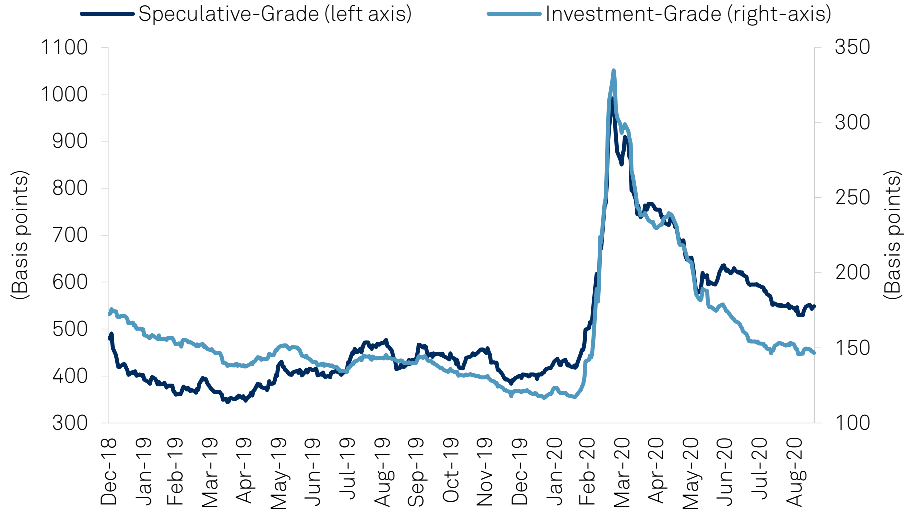
Sources: Thomson Financial; S&P Global Ratings.

Perhaps appearing as a reaction to the wave of protests and increased COVID infection rates outside of New York, speculative-grade spreads in the U.S. increased briefly in June before falling again (see chart 3). Meanwhile, the investment-grade space seems to have avoided even this brief return of risk, with its spread now lower than where it was in June 2019, coming in at 147 basis points (bps) on Sept. 18.

Market pricing has historically been a good predictor of future default rates and the above declines seen since March are now reflected in our optimistic case for our speculative-grade default rate forecast through June 2021 of 4% (see chart 4). This is notable as it reflects a decline from the current reading of 6.2% through August.

Chart 3

Corporate Credit Markets Reflect Only Moderate Risk

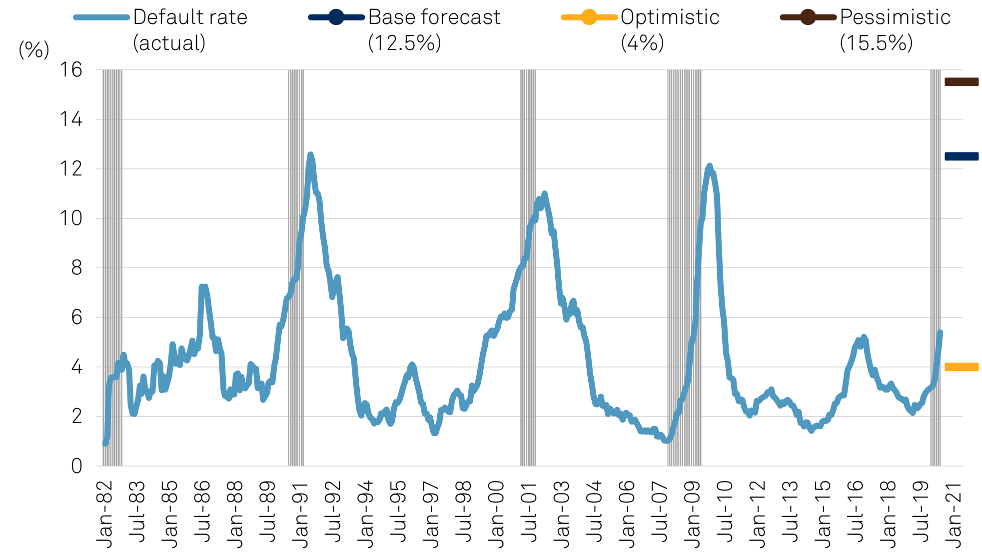


Source: S&P Global Ratings.

Nonetheless, credit fundamentals remain weak for speculative-grade firms, highlighted by the proportion of 'B-' and 'CCC'/'C' ratings hitting all-time highs in the past six months. This, along with mixed economic data and an expected slow recovery, keeps our base-case forecast for the speculative-grade default rate elevated at 12.5% through June 2021.

Chart 4

U.S. Trailing 12-Month Spec-Grade Default Rate And June 2021 Forecast



Note: Shaded areas are periods of recession as defined by the National Bureau of Economic Research.
Sources: S&P Global Ratings and S&P Global Market Intelligence's CreditPro®.

Historically, credit, economic, and market measures are leading indicators of defaults. However, since February, markets have diverged from fundamentals by a monthly average of 451 bps. We base our estimated spread on economic and equity market sentiment, and money-supply indicators. At the end of August, it reached 987 bps, compared to the actual spec-grade spread of 544 bps. The gap between these two measures had started to decline in June and reached 381 bps in July. With this August reading, the implied spread and actual have widened this gap, and even more telling, are moving in opposite directions.

Pockets Of Risks

Compared to late March and early April, when the capital markets were roiled by the pandemic and oil price shocks, ratings actions have declined considerably and are roughly 10% of weekly volumes seen during the peak period. We have seen a changing composition of ratings actions since the summer (see chart 5)—though fewer in number, downgrades have become more prominent, resolving prior negative outlooks or placements on CreditWatch with negative implications, which dominated rating actions in the early part of the crisis.

Additionally, negative outlooks have been higher in number than CreditWatch placements, which is particularly important as they carry a one- to two-year horizon for expected rating action versus 90 days (see "S&P Global Ratings Definitions," published Aug. 7, 2020). This extra time allows for negative conditions to potentially improve, increasing the possibility for some of these negative outlooks to be resolved with stable outlooks revisions (and without a downgrade).

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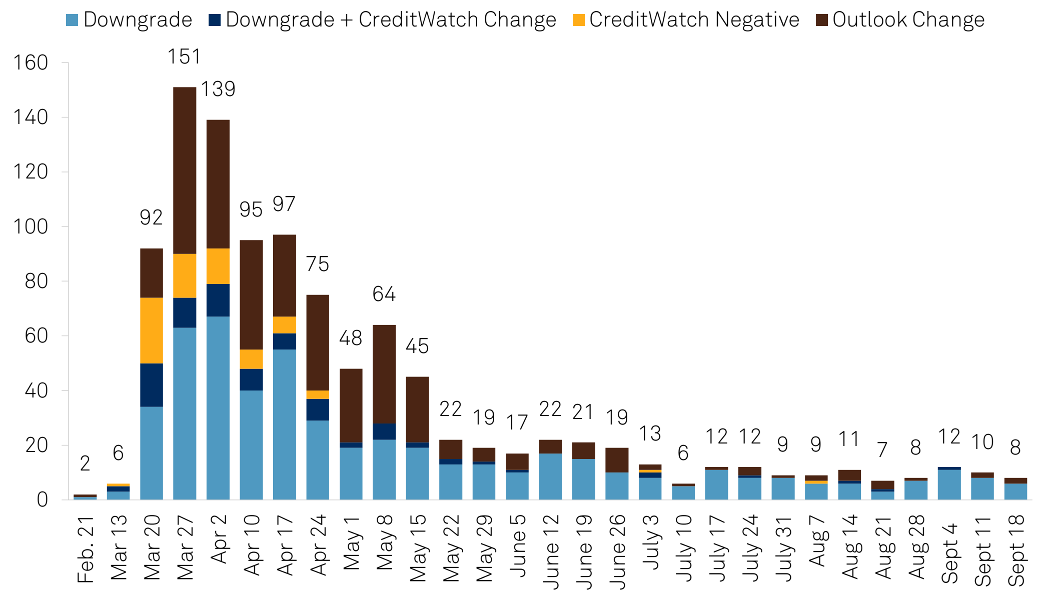
Chart 5

Weekly Distribution Of North American Issuers Affected By COVID-19 And Oil Prices By Action Type



Source: S&P Global Ratings.
Note: Data as of Sept. 21, 2020. Rating actions are tracked at an issuer level. If an issuer has had multiple rating actions since Feb. 3, the last rating action date is reflected in the chart above.

Since the onset of COVID-19, downgrades for nonfinancial companies have represented roughly 26% of the rated portfolio in North America, higher than financial institutions (8%). By comparison, roughly 5.5% of the structured finance rated portfolio suffered negative actions, primarily consisting of CreditWatch negative placements.

Corporates industries have also been stressed by the pandemic and oil price dislocations. Namely, airlines have faced significant pressures as travel demand remained weak through the summer holiday period. Chemicals have been hit hard given the destruction of demand in important end markets such as autos and general industrial. The auto sector may show some stabilization with potentially higher demand than other transportation modes, but its high fixed-cost nature may still impede profitability.

Looking ahead, pockets of risks are emerging in North America, and they could have broader implications on the economy and credits across our ratings practices.

Uncertain Policy Environment

The 2020 U.S. presidential election is well underway, with all 435 seats in the House of Representatives and 35 of the 100 Senate seats also at stake. This year's unprecedented voting challenges associated with the pandemic increase the risk of a disputed election that could roil financial markets and trigger more civil unrest (see table 1). In any event, the election results are going to shape the country's trajectory in the coming years. Recognizing that any significant legislative change will depend on the ultimate combination of partisan control of the White House and Congress (and that not all campaign rhetoric will necessarily transform into government policy), we are closely following developments in the following areas, which could have notable economic and credit implications:

Economic recovery measures: Federal fiscal stimulus and unemployment benefits are crucial to support the economy's climb out of the pandemic-induced shock. While both the Trump-Pence and Biden-Harris campaigns put economic recovery and jobs at the top of their respective agendas, and have indicated their intentions to boost infrastructure investment (with the Biden campaign calling for $2 trillion in spending on sustainable infrastructure over four years, and President Trump promising to "build the world's greatest infrastructure system") the volume and timing of any package remains to be seen. Meanwhile, premature fiscal austerity could result in another slump in public-sector demand before private-sector demand fully recovers, which could in turn dampen economic growth and weigh on credit quality across sectors, including state and local governments.

Taxation: Campaigning on the premise that the federal income tax regime needs to be retooled to ensure that corporations and the wealthiest individuals are paying "their fair share," Mr. Biden has pledged to reverse some of the Trump Administration's tax cuts. Notably, he proposes raising the corporate tax rate to 28% from 21% (although that would still be below the 35% nominal rate before the Tax Cuts and Jobs Act [TCJA] of 2017). Additionally, he plans to reinstate the Corporate Alternate Minimum Tax that was repealed by the TCJA at 15% of book income for companies that have more than $100 million of U.S. net income and pay no U.S. taxes. Such measures could hurt companies' bottom line and cash flows—although it is too early to draw any broader conclusions.

Health care: Health care has been a top campaign issue, and the loss of insurance for many individuals due to job losses stemming from the recession casts a harsher spotlight on issues of health care access and costs. There seems to be more momentum for changes on the Democratic side, as the Biden-Harris campaign has stated an intention to expand the Affordable Care Act and provide a public option for coverage. In the meantime, both campaigns are taking aim at pharmaceutical costs—with President Trump recently signing a series of executive orders designed to lower drug prices. Pending specific details around the campaigns' health care platforms, we believe we'd see increased possibility for more significant policy changes under a Biden administration than in a second Trump term.

Climate change: Mr. Biden's clean-energy plans could have a profound and direct effect on offshore oil and gas production, and the U.S. energy sector more broadly. A promise to ban "new oil and gas permitting on federal lands and waters" could weigh on many oilfield services companies, especially offshore drillers, given potentially significant effects on capital spending. For midstream energy, it would remain difficult to build greenfield pipelines regardless of who occupies the White House. Refineries could benefit from a second Trump term, but would likely continue to diversify into renewable projects to offset slowing demand growth.

Trade and supply chains: The two campaigns appear to converge on the idea that U.S. trade policy hasn't worked to America's advantage. President Trump's efforts will likely keep in line with his "America First" foreign policy, whereas Mr. Biden's approach is multilateral, working with allies to achieve the U.S.'s trade and economic goals. At the same time, we don't see the U.S.-China strategic confrontation going away in the near term, regardless of who is president. With the "Phase One" deal at a virtual standstill and tensions rising elsewhere, more protectionist policies could add downside risk for the U.S. economy. On the other hand, some corporate sectors such as autos, technology, and capital goods could benefit from less uncertainty around tariffs and more clarity in decision-making, which could come from a Biden administration.

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USPF=Under Significant Pressure Fiscally

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The year started with three U.S. public finance (USPF) sectors on negative outlook: higher education, ports, and mass transit. Following dire economic forecasts for the U.S., we revised the sector outlooks on all remaining USPF sectors to negative from stable on April 1. The sector outlooks have remained negative since that time, reflecting ongoing pressure that credits face across the country. To date, we have taken more than 1,600 ratings actions (see "COVID-19 Activity In U.S. Public Finance," published Sept. 24, 2020). Most of these have been in state/local governments, transportation, and higher education. With additional federal stimulus uncertain by year end, we expect there could be additional credit pressures across USPF.

State and local governments at a crossroads: With revenue deterioration widespread, most state and local governments are seeing growing budget gaps. Federal funding for COVID-19 expenditures under the CARES act has been important to offset pandemic-related spending increases, but it hasn't offset lost revenues. Premature fiscal austerity from the federal government would extend the timeframe for states and locals to regain fiscal balance, pushing the effects of the recession further out and weighing on GDP (with state and local governments accounting for about 11% of U.S. GDP). Many governments have started budget reductions, but absent additional stimulus will have to make deeper cuts, in some cases down to the level of public safety. In times of deep imbalances, we also see many governments making choices that affect long term credit stability, such as reducing pension contributions or deferring maintenance of and investment in key infrastructure.

Transportation demand drop-off continues to pressure airports and mass transit: While all transportation sectors are feeling some effects of COVID-19 and the recession, the airports and mass transit sectors have suffered the most credit pressures and downgrades. The fundamental shifts brought on by social distancing, teleworking, travel restrictions, and the lack of business travel are curbing activity and hurting operating revenues, in particular, leading to significant deterioration in coverage levels. The easing of mobility restrictions and people returning to work/school in some states in recent months has resulted in some increase in users, but not nearly enough to regain lost ground. Still to be decided but likely deferred until next year is the federal highway and transit authorization law that expires on Sept. 30. We anticipate a one-year extension and deferring any decisions related to resolving the looming Highway Trust Fund into the following year.

Higher education credit stability will be guided by fall enrollments: Colleges and universities are seeing weakened enrollments this fall due to pandemic-related social-distancing measures, and as a result will probably face reduced net tuition and auxiliary revenues. The recession will likely contribute additional budgetary stress in almost all other revenue sources, including reduced state funding for public institutions and lower fundraising for most colleges and universities. Although federal—and in some cases, limited state—COVID-19 and disaster aid provides some measure of stability, the potential amount of these funds relative to total pandemic costs, and associated receipt timing, is unknown.

Going forward, we are closely watching several risks that could impact USPF credits (see chart 6).

Chart 6

Key Risks We Are Watching

Uneven health recovery
Differences in state and local protocols and virus infection rates are influencing consumer demand, including services such as transportation and higher education

Recessionary pressures
Economic performance is uneven and continues to impact revenue collections

Federal funding and policy uncertainty
Stimulus has stalled and post-election policy shifts will be a key focus

ESG
Wildfires, hurricanes, and social unrest continue to affect credit

Source: S&P Global Ratings.

These risks are impacting USPF broadly; for views on more USPF sectors, please see chart 7.

Chart 7

USPF Key Sector Takeaways

State And Local Governments

States and some local governments see growing structural imbalances.

We expect to see uneven rebounds and revenue recovery across the U.S., driven in many places by the depth and duration of COVID-19 restrictions. Absent additional federal stimulus there will likely be significant budget reductions for states, local governments, and school districts in 2020 and 2021, and even into 2022.

Not-For-Profit Health Care

Uneven volume recovery, state fiscal pressures could exacerbate payor mix challenges.

Managements' actions to adjust expenditures and cost structure will be important for credit quality, especially given recessionary pressures and volume trends, including potential COVID case surges. Many hospitals and systems are supported by strong balance sheets, but we will continue to monitor reserves, liquidity, and short-term liabilities recently initiated in light of cash flow and margins.

Higher Education

Enrollment declines and event risk could lead to an uneven recovery.

Fall enrollments are heavily influenced by varied modes of operation, and the possibility of COVID-19 spikes leading to quarantines or a complete retreat off-campus. With most revenue sources down, budgeting and cash management will be critical. Student housing projects remain vulnerable to continued loss of revenues amid reduced occupancy driven by social distancing, occupancy restrictions, and online courses.

Transportation

Public transit and airports are most vulnerable to rating pressure.

As economic and social activities continue to tick up, mobility is on the rise accompanied by a recovery in demand indicators, albeit from severely depressed levels. However, while many workers and students return to old commuting routines, it is not enough to bring stability back to the sector, and airline travel still remains significantly down. Nearly all transportation issuers currently have a negative outlook.

Housing

Cashflows from senior and unenhanced rental housing face greater stress.

Housing issues' ability to meet debt service obligations could be pressured by phase out of enhanced federal benefits that were likely supporting housing payments, as well as the CDC's eviction moratorium through year end. We continue to monitor policy responses related to mortgage forbearance, eviction and foreclosures, as well as economic conditions and unemployment trends, to assess credit pressure for other housing subsectors.

Utilities

COVID-19 closures, recessionary pressures and extreme weather all affect demand.

We continue to monitor how commercial and industrial closures, elevated unemployment, and major natural disasters will affect utility revenue collections. To the extent that local governments' general fund revenues continue to realize unfavorable variances to budget, we are watching whether they look to plug shortfalls by extracting additional liquidity from utility cash from operations or cash reserves.

Charter Schools

State funding cuts/deferrals and event risk could pressure operating budgets.

Enrollment growth in high performing charter schools could offset some funding or cost pressures, but the ability of all charter schools to be proactive and manage expenses will be critical. Schools with weak enrollment trends and little financial cushion will have less flexibility to absorb cuts if necessary. Also watch for charter renewals that look different, increased unionization efforts, and upcoming elections that affect state charter frameworks.

Source: S&P Global Ratings.

Uneven Prospects For Corporates

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After entering the year with a median credit rating for corporates and sovereigns notably weaker than at the onset of the Global Financial Crisis, downgrades have moved the median rating even lower. The 'CCC+' level alone represents about 11% of all speculative-grade ratings, up from 5% pre-pandemic. As the economy begins its uneven recovery, we are evaluating companies' ability to improve credit quality, including whether issuers can adapt to pandemic-related changes to their businesses or even successfully manage the secular shifts already underway in their sectors. Even for higher-rated issuers, financial policy and governance will influence the rate of recovery in credit quality, especially as growth opportunities and acquisitions begin to look more enticing in a low interest rate environment. At the lower end of the rating spectrum we are seeing debt-financed dividend recaps, a sign that low rates and investor appetite for yield are more powerful than building liquidity or deleveraging. For example, at least ten debt-funded dividend transactions have been announced since mid-September.

Industries that rely on groups of people in close proximity—e.g., airlines, theaters, restaurants, retail—may not return to prior levels of revenue for several years. Under a scenario in which the U.S. is forced to reinstate lockdowns, these sectors that were hardest hit at the onset of the pandemic will again bear the heaviest burden. The pain could be even more acute if capital markets begin to seize, cutting corporations off from the liquidity lifeline that has thus far kept them afloat.

Given the deep shock to the U.S. economy, light-vehicle sales will likely decline more than 20% this year, and profitability headwinds for the auto sector will intensify due to the industry's high fixed costs. Cash flow will remain under pressure due to suboptimal demand and the buildup of working capital as production resumes, leading to a slow recovery in credit metrics that could take until 2023. Recent sales trends indicate modest upside to our base case for this year, as August saw the fourth consecutive sequential growth from the April low point of 8.6 million units. We expect a 10%-15% sales recovery in 2021, but sales will likely remain below the last 20-year median of 16 million even in 2022 as the sustainability of recent demand is questionable. At the same time, fear of the virus, government and corporate travel restrictions, and the recession have combined to destroy demand for air travel, and we don't see traffic rebounding to pre-pandemic levels before 2023. A recovery in airlines' revenues and credit measures could take years.

The lodging, leisure, and gaming sectors have faced unprecedented declines in revenue and cash flow, as well—and debt issuance has helped to support balance sheets and stave off near-term bankruptcies. But depending on cash burn rates, companies will be burdened with high-cost debt as they navigate recovery and the potential for years of lower revenue—and defaults and restructurings are inevitable. Meanwhile, the pandemic and economic shutdown forced many retailers and dine-in restaurants to close their doors (at least temporarily) although some have had success pivoting to takeaway demand, especially for quick service business models equipped with drive-through operations. For many nonfood retailers, e-commerce has surged, but the crisis will likely accelerate the already ongoing change in shopping habits, and retailers' capabilities may not be able to fully escape the financial burden of excess physical footprints quickly. On the bright side, revenues for telecom and technology with recurring revenues have remained relatively intact, and business services has proven resilient by being nimble in meeting corporate demands. With an increased time spent at home, homebuilders, building materials, certain retailers (décor, fitness equipment, electronics, etc.) are benefitting from consumers' interest in improving their living conditions. Health care providers, such as hospitals, saw patient and procedure volumes collapse in late March and April during the early part of the pandemic, but they've been recovering quickly. June and July volumes are generally within 10%-20% of pre-COVID-19 levels.

At any rate, the pandemic ushered in a massive increase in corporate debt issuance, with the year-to-date total of roughly $2.2 trillion through early September—42% more than the same period in 2019. However, with the exception of the growing cohort of borrowers in the 'CCC' category, we believe most corporates have adequate debt-service capabilities in the medium term, assuming that credit markets remain accommodative and economic growth resumes in the second half. One sign that higher debt levels are sustainable (due to low interest rates) is that while corporates' debt to EBITDA has risen overall, EBITDA to interest coverage has improved (with the caveat that investment-grade companies boast better interest coverage than their speculative-grade counterparts do). Still, the higher debt could delay the recovery of credit metrics beyond simply a rebound in revenue and earnings, into 2023 and beyond. While the maturity wall has been pushed out for speculative-grade issuers even during the crisis, debt maturities should not be forgotten, even if they are not top of mind in 2021.

Commercial Real Estate Faces Challenges

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The commercial real estate (CRE) sector has become an area of focus during the pandemic, largely due to pockets of weakness in retail and lodging. There is also some debate about the future of office markets—especially in densely populated gateway cities—and how certain urban multifamily markets will perform, given anecdotal evidence of people moving out of these metropolitan areas.

As it stands, the debt outstanding backed by CRE and multifamily properties has expanded significantly since the Great Financial Crisis, up nearly $1.3 trillion, to approximately $4.7 trillion as of the second quarter of this year. Banks hold roughly half of the debt (see table 2).

Table 2

	CRE (bil. $)	MF (bil. $)	Total (bil. $)	%
Other	125.3	124.2	249.5	5%
Banks	1851.2	525.7	2376.9	51%
Insurance companies	430.7	164.7	595.4	13%
CMBS including agency CMBS	364.8	435.5	800.3	17%
GSE (balance sheet)	0	368.6	368.6	8%
Pension/retirement	36.6	4.9	41.5	1%
REIT/finco	211.5	15.8	227.3	5%
Total	3020.3	1639.2	4659.5	100%

CRE—Commercial real estate. MF—Multifamily. GSE—Government-sponsored enterprises.
Sources: Federal Reserve Bank; S&P Global Ratings.

In general, insurance companies, pension funds, and REITs tend to invest in higher-quality, larger properties in primary markets. Banks may also invest in those markets, while also making smaller loans in secondary and tertiary markets. Commercial mortgage-backed securities (CMBS), including agency CMBS, tend to be a mixed bag, ranging from smaller loans in regional markets, to “trophy” properties in primary or secondary locations. Government-sponsored enterprises such as Fannie Mae and Freddie Mac continue to be active in multifamily lending, and when looking at both balance sheet and securitized lending, account for roughly half of that market.

With regard to pandemic-related distress we find that retail and lodging account for roughly 80% of both delinquent loans and loans that are in, or have requested, forbearance agreements in private-label CMBS. Digging a little deeper, it appears that the distress is largely in mall-based retail, and higher-priced lodging located in larger urban markets and fly-to destinations. Meanwhile, grocery-anchored retail, home improvement stores, and some larger retailers are generally performing well, while on the lodging side, limited-service properties, economy class, smaller cities and towns, and interstate properties are outperforming.

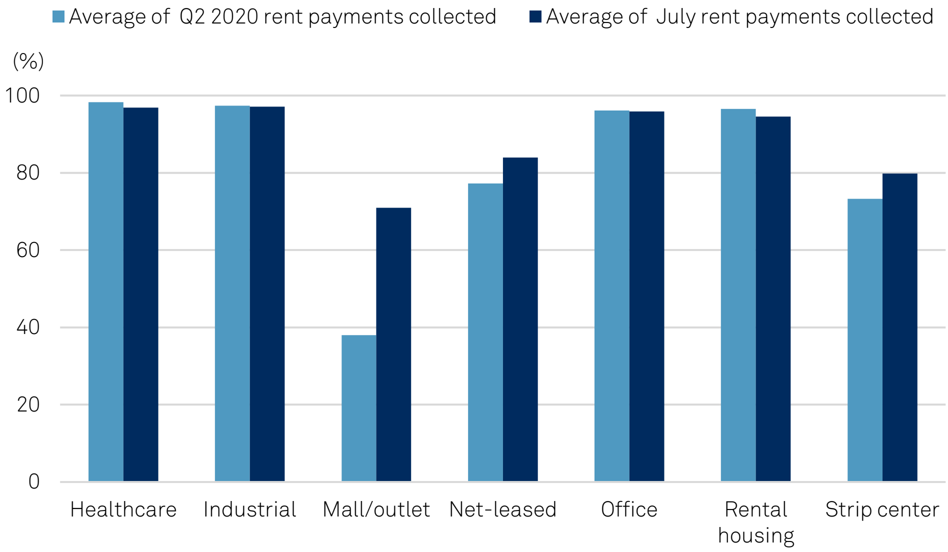
While rent collection for office properties remains high at around 90%, there is growing uncertainty about the longer-term need for office space. The perceived risks generally involve some combination of a population shift away from larger cities, the growing work-from-home trend, and corporate cost-cutting all leading to reduced demand, especially in central business districts. This, in turn would affect rents, vacancies, and values. On the other side are arguments about the positive aspects of collaboration, the need to train new or junior employees, and a potential coronavirus vaccine or effective treatment, all of which suggest that going to the office isn’t quite dead yet.

The multifamily argument/risk is somewhat simpler in the sense that it depends on population outflows from major cities to suburbs and smaller cities. Coincidentally, this could benefit the market for suburban offices.

Either way, there isn’t yet enough hard data available to conclude if a significant percentage of rolling office leases aren’t being renewed, whether corporations are exploring alternative spaces in suburban locations, etc.—and that data might not be available for some time. Also worth mentioning is that office leases are typically for longer terms, on the order of 10 years or more (some have mentioned that a consequence of the pandemic would be for tenants to negotiate for shorter terms), so potential distress would likely take place gradually, over an extended period of time. At least for now, through July, office rent collections have remained steady, and high (see chart 8), with similar results for rental housing.

Chart 8

Cash Rent Collection By Subsector



Source: S&P Global Ratings.

It also seems that values have declined commensurately. According to the Green Street Commercial Property Price Index, malls and lodging properties (institutional quality) are off 20%-25% from pre-pandemic levels, offices are down 9%, multifamily 8%, and industrial, which has benefited from a surge in e-commerce, is up 2%.

Related Research

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- U.S. Firms Face Calls To Cut Chinese Supply Chains, But See Few Options, July 30, 2020
- U.S. Corporate Credit Midyear Outlook 2020: Pitfalls And Possibilities, July 16, 2020

This report does not constitute a rating action.

Appendix 1: COVID-19 Impact On North America Nonfinancial Corporate Sectors

For analytical contacts, please see Appendix 6.

Table 3

COVID-19 Impact On North America Nonfinancial Corporate Sectors

Sector	Impact*	Comment
Aerospace and defense	High	The chilling effect of COVID-19 on air travel and the global economy is weighing on aircraft demand, on top of the 737 MAX grounding. Slower recovery in air travel will prolong recovery for manufacturers and aircraft suppliers, resulting in ongoing pressure on earnings and cash flow. Commercial aircraft deliveries will likely be 30%-40% below 2019 levels next year with gradual increases thereafter as air travel recovers. The rebound in aftermarket demand will likely be slower than recovery in air traffic due to the large number of retired aircrafts. The effect on defense contractors should be modest, with some disruptions due to facility closures. Defense spending could be slightly below previous expectations as the government extends substantial spending in economic relief to offset the impact of the pandemic.
Autos	High	With heavy investment needs, tariffs, and regulatory compliance costs, the auto industry entered the crisis with more profitability pressure and restructuring needs. We project that light-vehicle sales will decline 20%-22% in the U.S. this year. Recent sales trends indicate modest upside to our base case—August sales recorded the fourth month of consecutive growth from the April low. In addition, we expect a 10%-15% sales recovery next year, but it will likely remain 5%-10% below 2019 levels even in 2022. Nearly all issuers will end the year with a higher debt load than they began it with. Therefore, we expect profitability and cash flow adequacy metrics to be weaker next year compared to 2019 levels. Liquidity support for many aftermarket suppliers is crucial for the next stage as they look to build working capital to support supply restoration.
Building materials	Medium	The building materials sector is showing resilience in the face of COVID-19 disruptions. Revenue boomed in the spring-summer building season in North America, as consumers redirected discretionary spending into their homes amid lockdowns. The outlook for credit quality in building materials is bouncing back in the second half, with negative outlooks receding to below 50% of the portfolio. A negative bias will nevertheless persist into next year because of elevated leverage brought by inadequate profit growth entering 2020. Many issuers in building materials are operating with high debt levels after several years of mergers and acquisitions, and elevated costs for business restructuring add pressure on credit measures. Residential building materials appear well positioned in the next few years due to the constant demand for repairs and renovation. On the contrary, commercial construction could remain weak for several years, while new infrastructure spending is often too difficult to foresee due to political uncertainties. Discretionary or labor-intensive categories could face a drag on revenue for a few years if employment and confidence remain weak or if social distancing remains an important consideration for consumers.
Capital goods	Medium	The effects of COVID-19 and the sharp economic contraction have resulted in significant revenue and EBITDA declines in the second quarter, pressuring the credit quality in the capital goods sector. We expect conditions to improve in the second half and the declines to moderate in the third and fourth quarters. We still expect revenue to decline in the 10%-20% range and a 15%-30% EBITDA decline. The extent of the effects depends on the issuers' exposure—those in weaker end markets such as oil and gas, autos, commercial aviation, and metals and mining face greater pressure. We expect a multiyear recovery, with credit metrics returning to pre-COVID levels by 2022. A gradual recovery in industrial manufacturing activity, along with more end market capex spending driven by economic growth, would support the expected recovery of the sector.
Chemicals	Medium	The pandemic-induced recession across the globe has reduced demand in the second quarter of this year, hurting 2020 operating performance for most chemical products. The few exceptions to this were chemicals sold in end markets such as packaging, health care, cleaning and sanitation, and similar applications. We continue to believe that credit metrics at the end of the year will be in general much weaker than 2019 levels. The sector remains vulnerable to external shocks, including a prolonged recession. A recovery in the sector will largely depend on an economic recovery and a recovery in crucial chemical end markets such as auto, housing, and general industrial.
Consumer products	Medium	We still expect a divergence in the performance of sectors in the consumer products universe for at least the next six to 12 months. U.S. consumer products companies in food, home-cleaning products, and hygiene are benefiting from consumer trends and behavioral changes associated with the pandemic, including increased at-home food consumption, higher levels of products in their pantries, a heightened personal wellness focus, and increased online purchases. Durable goods makers have been materially hurt by the

		economic impact of the coronavirus. These companies are highly cyclical, and their fates are directly tied to key macroeconomic indicators. For durables makers, we don't expect operating performance to recover until the latter part of next year. Credit metrics won't likely recover to pre-COVID levels until 2022 for most companies. For issuers in nondiscretionary categories, we expect growth to slow in the fourth quarter and to become negative starting in the second quarter of next year as they will be lapping strong comparisons. For categories such as beauty, apparel and food service, we don't expect a recovery until the second half of next year and some categories not until the first half of 2022.
Forest products	Medium	Credit risks in the cyclical and commoditized paper and forest products industry have eased somewhat in the past quarter. Unexpectedly strong demand for repair/remodeling activity and new home construction has resulted in record-high lumber and panel/other wood product prices over the past quarter. Inventory remains tight for now and should result in improved profitability and cash flow for companies with residential housing exposure this year. Pulp and paper markets have largely remained soft due to excess capacity amid lower business demand for paper in light of COVID-19. That said, packaging markets have remained fairly resilient, supported by the growth in e-commerce during the pandemic. Ongoing paper supply curtailments owing to structural demand declines will likely accelerate and provide some price stability.
Gaming, leisure and lodging	High	Travel bans, stay-at-home orders, and restrictions on consumer activity have significantly loosened, but nearly all cruise, lodging, theme park, fitness, and sports issuers are still facing diminished revenues and ongoing cash burn. Some regional gaming companies and outdoor recreational activities like RVs and boats, are faring better. The debt markets have been financing incremental debt to cover cash burn with much less stringent terms and conditions than in the second quarter. While issuance has helped to bolster balance sheets and stave off near-term bankruptcies, depending on cash burn rates companies will be saddled with a significant amount of incremental (and in some cases high-cost) debt as they navigate recovery and the potential for years of lower revenues. As various U.S. states continue to reopen, some subsectors such as local drive-to markets and outdoor recreational activities are recovering faster. Given the material impact COVID-19 has had on the sector, we believe there is potential for longer-term structural changes that could have a lasting impact on credit quality. This could include properties that never reopen, permanent supply and demand imbalances, and disruption to operations that could affect future profitability. As a result, for many sub-sectors, we expect a multiyear recovery for credit metrics to reach to pre-pandemic levels.
Health care and pharmaceuticals	Medium	Recovery from the pandemic has been stronger than expected, with patient volumes and procedures, which declined significantly in the early months of the pandemic, recovering to 5%-10% of pre-COVID-19 levels, though some areas, such as emergency services, are still lagging at 15%-20% below. The pharmaceutical industry was much less hurt and should see near full recovery by year-end 2020. Still, we believe uncertainty remains high, especially as states reopen and we enter the back-to-school months, increasing the chances of a spike in COVID-19 cases and leading to another drop in patient volumes and procedures. As the industry continues to recover, the focus shifts back to reimbursement and pricing, which continue to pressure the industry's profitability and cash flows. Health care access, quality, and cost remain major themes and the industry was undergoing major disruption on the payor and technology side. The COVID-19 pandemic accelerates that disruption, such as the move to value-based care models and telehealth. The looming U.S. presidential election will also put a harsh spotlight on the industry, elevating the threat of significant legislation post-election.
Homebuilders	Medium	The credit quality of U.S. homebuilders had significant buffer to withstand a sharp slowdown. Industry conditions resumed their multiyear strength after a pause in March and April of this year. Record-low mortgage rates and resilient first-time buyers drove monthly home sales above 2019 levels for many homebuilders by July or August. Slower foot traffic for social distancing has given way to digitizing parts of the purchase and better sales conversion from more serious buyers. We still expect higher debt leverage from lower earnings in a few cases, but homebuilders generated countercyclical cash flows amid more conservative policies this year. Looking ahead, however, job losses could cloud the picture for new orders over the next few months.
Media and entertainment	High	The media sector remains under intense economic and secular pressures due to the COVID-19 pandemic. Ad-based media sectors such as television, radio, and outdoor, have seen sequentially improving advertising trends since the second-quarter 2020 bottom, as economic activity resumes around the country and sports programming returns. Still, we expect ongoing secular pressures from declining audience ratings will continue to pressure advertising revenues for traditional media. The outlook for out-of-home entertainment remains uncertain as many venues remain closed or under strict government-mandated social-distancing measures, which severely limit attendance, and those that have reopened, such as movie theaters, have seen weaker-than-expected attendance levels. More concerning for the pace of recovery, rising infection rates heading into the winter months may lead to governments globally reinstating more aggressive social-distancing measures, setting back any recovery in

		these media sectors. Longer term, even with a vaccine, lingering consumer fears about returning to large public events will ultimately affect any return to normalcy.
Metals and mining	High	Pressure on ratings in the metals sector is progressing much as expected with the concurrent COVID-19 and oil market downturns. The North American sector is already characterized by elevated credit risk, with almost 50% rated 'B' or lower and a 30% negative outlook bias since mid-2019. Spot prices have begun outperforming our modestly lower metal price assumptions, but the demand shock and production stoppages means that revenues could drop 10%-15% this year in these high fixed-cost industries. Spec-grade issuers could breach leverage triggers with 2021 maturities on the horizon. The outlook for many metal producers remains weak, as indicated by multiyear slowdowns for metal consumers in the automotive and aerospace industries. We expect volumes will lag in those key industries, so that a rebound to 2019 volumes now appears to be in 2022. If the downturn extends beyond 2022, we expect near-terminal damage to some assets and competitive positions because of global pressure and ESG considerations as the steel industry aims to reduce high greenhouse gas emissions from carbon steel. Otherwise, base metals miners are rebounding off cyclical low prices with few rating changes because of the natural supply destruction in a downturn.
Midstream energy	High	The sector has somewhat stabilized in the third quarter with cash flow declines slightly easing. However, the sector outlook remains negative. About 37% of the portfolio is on negative outlook or CreditWatch negative. Despite commodity prices showing signs of a rally, distress continues among oil and gas producers. We expect declines from lower production will manifest itself next year. Volume declines and counterparty credit quality are the top risks to the sector but the uncertainty around the timing and pace of any recovery makes it difficult to predict the severity of impacts on midstream credit profiles. We believe the midstream sector recovery will largely be in sync with an improvement in the upstream sector. While that may take time, midstream companies can redirect excess cash flow to repay existing debt, thus improving credit quality even with a delay in upstream improvement.
Oil and gas	High	COVID-19 has significantly affected oil market fundamentals. Following unparalleled demand shock, oil prices have rebounded from their lows in mid-April, largely because of massive supply cuts from OPEC and Russia and the gradual reopening of global economies. However, oil prices are still not at levels that support North American upstream credit quality. Furthermore, investor sentiment is still negative for issuers in the spec-grade space and many of these issuers lack access to capital markets and are facing heavy debt burdens. Of upstream issuers, 40% are rated 'CCC+' or lower. Ultimately, we still assume Brent oil price will recover to $50 per barrel (bbl) next year, from $40/bbl this year. More recently, oil prices have been trading slightly weaker given concerns about demand and a resurgence of the coronavirus. An increase in oil prices faces headwinds given lackluster global refinery margins and high crude and product stocks. It will likely take some time before oil demand rebounds to pre-pandemic levels, largely due to a lag in aviation and a slow rebound in global economies. However, OPEC will continue to be supportive of prices even if demand falls further.
Oil refineries	High	The refining sector will see modest improvement in the third quarter but will still have profitability and cash flow that is well below mid-cycle conditions and lower credit metrics compared to third quarter last year. Independent oil refiners' margins are under pressure from lagging demand, which is eroding cash positions. A number of refineries responded to the drain on liquidity with new short-term bank facilities and successful debt issuance of more than $8.1 billion in the second quarter. We now expect the recovery to be pushed out until the second half of next year and possibly into 2022. Demand for fuel is generally lagging with economic activity down and travel significantly curtailed. Refineries are trying to mitigate weak demand by keeping utilization in the mid- to low-80% area and converting refining capacity to renewable bio-diesel or shuttering. A prolonged demand response due to COVID-19 could further weaken credit quality.
REITs	Medium	REITs faced significant earnings pressure in the second quarter of this year, which is in line with our expectations due to the impact from the lockdown, store closures and social-distancing measures. Retail and senior housing assets were most affected. Senior housing assets were impacted as low move-ins hurt occupancy. Rent collection has improved following store reopening for retail properties, increasing to 80% range from 40%-50% with malls collecting the least and net lease assets collecting the most within retail real estate. Rent collection for most property types remain resilient at above 90%. We expect a multiyear recovery with credit metrics recovering to pre-COVID levels by 2022, though retail and office could take longer. Gradual economic growth driving employment and consumer spending should support recovery in real estate demand, though potential for longer term changes in consumer behavior could result in greater pressure in retail, office, and multifamily assets.
Regulated utilities	Low	We believe that most North American regulated utilities are well positioned to handle the immediate impact of COVID-19. However, the negative outlook reflects the minimum financial cushion that companies are strategically operating under. The pandemic could continue to add pressure, especially those issuers facing weaker financial measures and downside ratings pressure pre- coronavirus. We expect recovery to occur in the first half of 2022, reflecting utilities filing with their regulators for relief of COVID-related costs.

Retail and restaurants	High	Although credit risks in the retail and restaurant sector remain elevated due to uncertainty around containment of the pandemic and the financial health of consumers, we are starting to see recovery or stabilization in some areas. Margin and cash flow adequacy will continue to be weak for most issuers due to pressure on the topline and increased costs for health and safety. We expect ongoing credit quality pressure in the hardest-hit areas of retail and restaurants (mall-based retailing and dine-in restaurants) as these continue to be the most exposed to the effects of coronavirus containment measures and consumers' preference for social distancing. In the longer term, retailers and restaurants will have to adapt to changed consumer shopping habits, such as a higher proportion of spending via digital channels, and incremental costs associated with health and safety measures. We don't expect 2019 levels of mall-based retailing to return for years, if ever. On the other hand, consumers have shifted expenditure from travel, dining out, and other leisure activities to products and services that enhance life at home.
Technology	Medium	Our view of the sector outlook is similar to that of last quarter, mainly because the macroeconomic weakness that was largely caused by COVID-19 and the mitigation policies remain. Since IT spending is correlated with global GDP growth, tech companies, especially hardware vendors that rely on large transactional revenues, continue to see customers hesitant to make large purchases or spend on growth-oriented projects. However, our earlier concerns related to supply chain disruptions that started in China, the original epicenter of the pandemic, have caused less severe trouble than expected. Liquidity isn't a major concern for the sector following the Fed intervention in the second quarter. Tech companies have been able to access the debt capital market for additional liquidity, if necessary. We expect software and semiconductor segments to grow this year. The hardware segments will likely experience revenue declines in 2020, with credit metrics returning to 2019 levels in the second half of next year. Similarly, IT services will likely see a low-single-digit decline but expected to return to growth in 2021.
Telecom	Low	Overall, telecom and cable providers can withstand the effects of a surge in COVID-19 cases with limited impact to credit quality given their recurring, subscription-based business models. However, there are a handful of companies that have exposure to vulnerable sectors such as transportation, retail, and tourism, which hurt their year-to-date financial and operating performance. In addition, issuers that have exposure to small- and mid-sized business (SMB) customers are at risk since they are most likely to reduce telecom spending in a recession. We believe that SMB customers, in particular, will likely scale back operations and in some cases, will go out of business.
Transportation	High	All transportation remains under pressure from COVID-19 and the related economic recession, but severity varies significantly by subsector. Airlines face unprecedented drop in air traffic and massive losses. Car rental is experiencing similar effects seen in airlines due to its complementary nature of relying on airport rentals. The aircraft-leasing sector is also facing pressure on the revenues and cash flow side but faring better than airlines. Freight transportation (trucking and railroads) is generally in better shape. The recovery in air traffic now looks weaker than previously expected. We project global air travel to reduce 60%-70% this year followed by a weak recovery next year, which would leave traffic still 30%-40% below 2019 levels. We expect a possible return to pre-COVID levels only by 2024.
Unregulated (merchant) power	Medium	Most merchant power companies engage in ratable hedging and a high proportion—typically 90%—of their 2020 economic generation is hedged. We expected companies with load shape risk (volumetric risk in hedges) and/or a higher proportion of large commercial and industrial customers to be disproportionately affected but load has improved after initially trailing off and larger corporates with countercyclical retail power operations have fared better than smaller companies. Most retail power business have offset the EBITDA loss in wholesale power. Our attention has now moved to how forward power prices are moving for 2021. Typically, forward prices start increasing four to five months before the end of the previous year as liquidity and trading volumes improve. So far, 2021 prices show signs of increasing but could be influenced by a second COVID wave.

*The impact descriptor above (high, medium, low) is our qualitative view of the risk. It does not directly translate to risk of rating actions, which depend on a number of factors including initial headroom under a rating coupled with the expected length and severity of the epidemic.

Appendix 2: Structured Finance Sector Trends

Year-to-date through Sept. 11, a total of 1,991 North American structured finance rated tranches (about 5.5% of our rated tranches in North America) have experienced at least one rating action due to the pandemic and/or the decline in oil and gas prices. That includes 1,366 downgrades, 314 CreditWatch negative placements, 42 downgrades accompanied with CreditWatch negative placements, 262 affirmations, and 7 withdrawals. At this point we have resolved roughly three-fourths of the original credit watch placements stemming from the pandemic and/or oil and gas prices.

Overall, most of the actions have affected speculative-grade classes, albeit with some sectors experiencing movement in the low-investment-grade realm, and others seeing more idiosyncratic actions at high investment grade categories. Areas of focus include CMBS with high exposure to retail and lodging, auto dealer floorplan asset-backed securities (ABS), non-qualified-mortgage (QM) residential mortgage-backed securities (RMBS), aircraft ABS, subprime auto ABS, collateralized loan obligations (CLOs), whole business ABS, small business ABS, and timeshare ABS.

Going forward, our collateral performance outlook remains somewhat weaker to weaker across the board, and our ratings outlook is mostly stable to negative or stable for most asset classes. We're seeing more "stable" entries this quarter versus the second quarter—some of which is due to the structured credit/esoteric ABS area (see table 4).

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Table 4

North America Structured Finance Sector Trends (12-Month Outlook) Q3 2020

	Collateral performance outlook	Rating trends
Residential mortgages		
RMBS	Somewhat weaker	Stable to negative
RMBS - servicer advance	Somewhat weaker	Stable
Commercial mortgages		
CMBS - N.A. conduit/fusion	Somewhat weaker	Stable to negative
CMBS - large loan/single borrower	Somewhat weaker	Stable to negative
CMBS - large loan/single borrower (retail)	Weaker	Stable to negative
CMBS - large loan/single borrower (lodging)	Weaker	Stable to negative
Asset-backed securities		
ABS - prime auto loans	Somewhat weaker	Stable
ABS - subprime auto loans	Weaker	Stable to negative
ABS -auto lease	Somewhat weaker	Stable
ABS - auto dealer floorplan	Somewhat weaker	Stable to negative
ABS - credit cards	Somewhat weaker	Stable
ABS - unsecured consumer loans	Weaker	Stable to negative
ABS - FFELP student loan	Somewhat weaker	Stable
ABS - private student loan	Somewhat weaker	Stable to negative
ABS - commercial equipment	Somewhat weaker	Stable
Asset-backed commercial paper	Somewhat weaker	Stable
Structured credit		
CLOs	Somewhat weaker	Stable to negative
Timeshares	Somewhat weaker	Stable to negative
Small Business	Weaker	Stable to negative
Tobacco	Somewhat weaker	Stable
Transportation - aircraft	Weaker	Negative
Transportation - container	Somewhat weaker	Stable
Transportation - railcar	Somewhat weaker	Stable
Whole business	Weaker	Stable to negative
Triple-net lease	Somewhat weaker	Stable

FFELP—Federal Family Education Loan Program. Source: S&P Global Ratings.

The ongoing weakness in the employment situation/overall economy, despite some improvement in the headline unemployment figure, has led to increased delinquencies and forbearance requests/extensions across many structured finance asset classes, including autos, RMBS, and CMBS. Therefore, structural features such as reserve accounts, servicer advancing, excess spread, and deferrable bonds/notes should—and have—help(ed) to mitigate temporary cash flow interruptions. We continue to note that credit risks remain generally on the downside. Still, we do not currently expect widespread credit contagion to arise from any of the structured finance subsectors that are under stress during the pandemic-driven economic crisis.

Appendix 3: Insurance Sector Trends

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Overall, the average financial strength rating for the core North American insurance portfolio (life, health, property/casualty [P/C]) resides at the upper range of strong ('A') category, unchanged from the prior quarter (see table 5). All credits in the mortgage insurance sector continue to reflect negative outlooks. Key risks include weakened economic conditions, pricing adequacy, profitability, investment yield, and policy factors. 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 specific current and emerging subsector risks more specifically.

Table 5

North America Insurance Sector Trends (12-Month Outlook) Q3 2020

Sector	Current business conditions	Business conditions outlook	Sector outlook
Life insurers	Satisfactory	Somewhat weaker	Stable
Health insurers	Satisfactory	No change	Stable
Property/casualty insurers	Satisfactory	No change	Stable
Reinsurers	Weak	No change	Negative
Bond insurers	Satisfactory	Somewhat weaker	Stable
Title insurance	Satisfactory	No change	Stable
Mortgage insurers	Weak	No change	Negative

Source: S&P Global Ratings.

Record-low interest rates, lower investment yields, and risk of impairments dampen **life insurers'** earnings prowess in the near term. However, capital buffers and hedging frameworks that have been proven to be effective, will limit any significant rating actions. The current environment has forced insurers to reprice their products, which makes them less attractive to the potential consumer. We expect a slowdown in fixed annuity sales this year. However, we don't see this as a long-term trend, and expect sales of retirement products to regain their positive trend as an aging population will continue to need more retirement solutions.

For **health insurers**, policy risk (political/regulatory) remains the No. 1 risk. The game-changing Affordable Care Act (ACA) is now 10 years old but it remains a work in progress—meaning that future policy changes lurk, particularly with the U.S. presidential election on Nov. 3. As for COVID-19, the economic and health-related fallout has been manageable for the industry, at least for now. The industry's commercial group membership hasn't dropped off as much as expected due to probable factors as such as furloughed employees that were able to keep coverage, COBRA, and spousal coverage. At the same time, Medicaid and individual market coverage, which are counter-cyclical, haven't increased by as much as expected due to these commercial market factors, as well as general logistical obstacles such as state enrollment backlogs.

Concerns about loss emergence is building enough momentum for the **U.S. P/C** insurance industry to find religion once again on pricing. We characterize this hardening rate cycle as loss-cost driven rather than capital-replenishment driven, as we saw in prior cycles. Although the pandemic hit capital levels in the first quarter, by the end of the second quarter most of this had largely rebounded. We still expect insurers to take caution with share buybacks as they look to preserve capital for the upcoming catastrophe season, loss and premium volume uncertainty related to macroeconomic conditions as well as utilize excess capital to grow rather than return to shareholders.

Sector capitalization for **global reinsurance** remains robust with no material capital destruction so far, benefiting from capital raises this year and market recovery from March lows. Most reinsurers halted their buybacks to bolster their balance sheets once COVID-19 became a real threat. Alternative capital capacity, especially collateralized reinsurance, will remain constrained in the near term as alternative capital providers are reeling from their capital being trapped for four years in a row and its underperformance over the past few years. In addition, reinsurers' investment returns will suffer during the next couple of years because of low interest rates and higher credit losses. As a mitigating factor, reinsurance pricing has been hardening during the past 18 months, with tightening terms and conditions, further supported by COVID-19 losses, which we believe will carry the positive reinsurance pricing momentum into next year.

As issuers have begun to re-enter the USPF market, **bond insurers'** have been able to capitalize on investor caution as they have experienced demand for insurance in the new issue market with insured penetration rising well above levels of recent years. Additionally, growth in insured secondary market issues continues strong as investors have proven to be credit sensitive. Overall business volume, however, may show limited growth this year due to the temporary issuance slowdown March through May. From an insured risk perspective, we don't expect defaults of issues insured by the bond insurers to be widespread, but there could be rating migration for some insured issues. We don't see these possible rating changes putting excessive stress on capital adequacy given the level of the of bond insurers' capital adequacy redundancy.

Revenue growth continues to be modest for **title insurers** in 2020. A significant decrease in residential and commercial mortgage originations in the second and third quarters due to the economic impact of the COVID-19 pandemic continues. Residential home purchase has begun to rise slightly, but still-low interest rates have led to an increase in residential refinancing which has somewhat offset the decrease in purchase originations. The overall profitability of the title insurers will depend on their ability to manage operations throughout the mortgage cycle. This is especially true in an environment where the product mix is more heavily weighted towards residential mortgage refinance volume and, as a result, the premiums are lower per transaction

Private **mortgage insurers** will recognize higher losses this year due to significant increase in mortgage delinquencies, however the average reserve per delinquent loan is lower than usual. This is because of higher cure rate assumption driven by economic recovery, leading to an improvement in the unemployment rate, and with forbearance relief and government support helping borrowers with the transition. Fairly valued house prices, strong mortgage portfolio credit quality, and low interest rates are supporting factors as well. So far, the number of delinquent loans outstanding improved in July and August from peak of June. As a result, reported losses this year could be contained within earnings, although a key sensitivity remains regarding the transition period when payment forbearance subsides

Appendix 4: Banks Sector Trends

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U.S. banks have prepared for the likelihood of elevated borrower defaults and have more than doubled their allowances for loan losses. Our base-case projection is that the pandemic will trigger loan losses of 3% through next year, forcing banks to provision more than $330 billion cumulatively. This amounts to about half of the 6.3% loss rate the Fed projects for the 33 banks part of the 2020 Dodd-Frank Act Stress Test (DFAST). We estimate that the banks that participate in the stress test have taken provisions of 1.5% through the first half of this year; the rated banks that don't participate in the stress test have taken provisions of 1%. So we expect elevated provisions to continue but at a lower rate than second-quarter levels.

In the first half, the ratio of allowances to loans for rated U.S. banks rose to a median 1.7% (from 1.0% at year-end 2019) and an aggregate 2.7% (from 1.3%). In other words, rated banks increased their allowances by an amount equivalent to roughly 1.4% of loans. At the median, the allowances of DFAST banks (which are the country's largest) equated to 40% of DFAST loan losses. The allowance of other rated banks equated to just 30% of their implied DFAST losses (based on their loans mixes).

We believe most rated banks could generate enough pre-provision net revenue to remain profitable over the next four quarters assuming that they need to build provisions in line with our base loss rate and that their pre-provision revenue will stay in line with second-quarter levels.

Loan deferral rates, too, could be a leading indicator of the ultimate charge-offs banks will incur. We estimate that, through the second quarter, the median deferral rate for all loans was about 8%, led by the CRE asset class, with a 12% deferral rate. There is a wide dispersion, though, among banks regarding total loan deferral rates, with some at the upper end posting deferral rates higher than 20%, and those at the lower end less than 5%. Based on management comments in the third quarter, deferral rates seem to be declining. Ultimately, the extent of the U.S. government's ability to provide additional fiscal stimulus, along with the trajectory of unemployment rates, should determine to what extent loan deferrals turn into charge-offs for U.S. banks.

This, on the back of about $115 billion of provisions in the first half, represented major progress toward absorbing the loan losses likely to result from the economic downturn.

Appendix 5: Economic Data And Forecast Summaries

Table 6

U.S. – S&P Global Ratings Economic Outlook

	2019	2020f	2021f	2022f	2023f
Real GDP (year % ch.)	2.2	-4.0	3.9	2.4	2.6
Real consumer spending (year % ch.)	2.4	-4.4	4.9	3.1	2.9
Real equipment investment (year % ch.)	2.1	-8.9	8.2	4.8	4.2
Real nonresidential structures investment (year % ch.)	-0.6	-9.3	2.8	3.5	4.2
Real residential investment (year % ch.)	-1.7	0.2	2.2	4.4	4.5
Core CPI (year % ch.)	2.2	1.6	1.9	1.9	1.9
Unemployment rate (%)	3.7	8.4	6.7	5.7	4.7
Housing starts (annual total in mil.)	1.3	1.32	1.33	1.36	1.36
Federal Reserve's fed funds policy target rate range (year-end %)	1.5-1.75	0-0.25	0-0.25	0-0.25	0-0.25

Note: All numbers are in annual average basis, except the Fed's policy rate and housing starts. Core CPI is consumer price index excluding energy and food components. f—forecast. Forecasts were generated before the third estimate of Q4 2019 GDP was published by the BEA. Source: Oxford Economics, S&P Global Economics Forecasts.

Table 7

Canada – S&P Global Ratings Economic Outlook

	2019	2020f	2021f	2022f	2023f
Real GDP (year % ch.)	1.7	-5.6	4.9	2.1	2.8
Real consumer spending (year % ch.)	1.6	-7.7	3.7	2.7	2.5
Real private business fixed investment (year % ch.)	-1.7	-15.2	4.9	10.3	3.9
Core CPI (year % ch.)	2.1	1.1	1.6	1.9	2.0
Unemployment rate (%)	5.7	9.6	7.7	6.9	6.4
Housing starts (annual total in thousands)	208.7	201.8	177.6	205.0	215.9
CAD/USD exchange rate (per US$1)	1.33	1.35	1.39	1.39	1.37
Government of Canada 10-year bond yield (%)	1.59	0.77	1.34	1.99	2.22
Bank of Canada overnight rate (%, end of period)	1.75	0.25	0.25	0.25	0.25

Note: All numbers are in annual average basis, except central bank rates and housing starts. Core CPI is consumer price index excluding energy and food components. f—forecast. Source: StatCan, Oxford Economics, S&P Global Economics Forecasts.

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