Global Credit Outlook: Back On Track?

December 3, 2020

Key Takeaways

- **More downgrades in 2021.** Corporates and governments that we rate have a 36% negative bias, pointing to more downgrade potential in 2021. However, our base-case economic and credit assumptions do not suggest a large second wave of changes akin to the post-March adjustment to COVID-19. Instead, changes will reflect the widening outlook gaps between and within sectors and regions. Sectors hit hardest by COVID will only recover by 2022 or later; those least affected should be back on track next year.

- **Recouping COVID-19 costs will take time.** After peaking at 265% of global GDP at the end of 2020, global leverage is likely to ease only slightly in 2021, and mostly as a result of a rebound in global GDP. With vaccine availability and a 5% rebound in the global economy, the focus in the second half of 2021 will likely turn to the gradual unwinding of extraordinary fiscal support, revealing the extent of credit losses for banks. Governments face the difficult task of balancing near-term risks of premature austerity with a medium-term need to curb debt expansion.

- **Defaults will continue to rise.** Even though we expect very low funding costs through 2021, higher leverage and a large share of vulnerable corporates are likely to induce further defaults, resulting in the 12-month speculative-grade default rate rising to around 9% in the U.S. and 8% in Europe by September 2021, versus 6.3% and 4.3% in September 2020.

The pandemic and its aftermath will continue to dominate credit conditions in 2021. Recent vaccine developments offer a clear route out of the acute phase of the crisis. Our central assumption remains that COVID-19 will come under control very gradually through a combination of vaccines, medical treatments, and testing starting from Q2 in developed economies, but more broadly only in the second half of the year. This should allow for many social-distancing measures to be lifted, a resumption of international travel, and a rebound in private demand. At that point, governments may be able to gradually phase out extraordinary fiscal support. Central banks are likely to keep interest rates exceptionally low and continue to offer liquidity support as necessary.

The aftermath of the crisis is likely to bring significant challenges for credit, despite the medical advances. The process of withdrawing stimulus is likely to be fraught, particularly as hidden vulnerabilities come to light. There could be significant aftershocks from a crisis of this magnitude that has wrought severe economic damage, necessitated a dramatic expansion of private and public debt, exacerbated already problematic levels of inequality and inter-generational imbalances, caused surging under- and unemployment, and undermined business models on which complex debt structures reside.

In any crisis, the first responsibility is to end it. That this end is now moving into sight is a mark of success and a genuine cause for cautious optimism. As with many crises, there are positive developments too: radical new health technologies such as the mRNA vaccines may help contain future viruses, and efforts to “build back better” with a transformation to renewable power could help contain climate risk. But high debt and disruption will warp and weft the economic fabric for years to come.

While the global economy is getting back on track, countries and regions are moving at different speeds. China was first in to the crisis and first out, and provides an interesting template of a robust manufacturing recovery, tempered by consumer caution. The U.S. and Europe, in particular, are mired in a challenging second wave of COVID-19 that has eroded recovery momentum. These economies will effectively limp into the new year. Nevertheless, prospects for a Q2 turnaround are supported by extensive vaccine purchases lined up by their governments, and an ability to handle the more onerous cold chain requirements of mRNA products. For emerging markets, vaccination is likely to be more challenging and financial pressures may hamper the pace of recovery.
The political tensions and outbursts of economic nationalism that have punctuated recent years are unlikely to fully recede in 2021, and may be exacerbated by the pandemic. Despite a more multilateral focus being the stated intent of the incoming U.S. administration, the view of China as a competitive threat will continue to hold sway and shape industrial policy on both sides. Tensions around the taxation and monopoly power of U.S. technology companies are likely to rankle relations with the EU. The conclusion of a limited trade deal between the U.K. and EU, still our base case, will only be the start of a new relationship and is unlikely to resolve all issues.

For credit ratings, more downgrades are likely. S&P Global Ratings’ rated corporates and governments have a 36% negative bias, pointing to more downgrade potential in 2021. 9% of non-financial corporates are in the ‘CCC’ category, a rating level indicating current vulnerability to default. However, the global backdrop provided by our base-case economic and credit assumptions does not suggest a large second wave of changes akin to what was necessary in post-March adjustment to the COVID shock. More likely is that changes will reflect the wide outlook gaps between and within sectors and regions that reflect the particular challenges of COVID, the recovery, and aftermath. Some specific themes likely to affect ratings trends are:

- **COVID containment.** Renewed lockdowns and distancing measures resulting from the second wave in the U.S. and Europe are continuing to reduce revenues and increase cash outflows in the sectors most exposed. The magnitude of this pressure is less than in the spring, and a positive liquidity environment has helped facilitate refinancing and bolstered cash levels. Yet, the extent of disruption has been greater than most expected and is likely to persist at least through the first quarter of 2021.

- **Unwinding support.** The mesh of schemes and subsidies providing loans, guarantees, and—in Europe especially—subsidizing labor will be gradually removed as recovery gathers pace and governments seek to remedy fiscal deficits. This is likely to put pressure on companies with unsustainable capital structures, prompting insolvencies or restructurings.

- **Asset quality and deficits.** The aftermath of the crisis is likely to reveal asset-quality stress that may affect some financial sector balance sheets, but this is likely to pose specific rather than systemic risk. Strong bank balance sheets, continuing liquidity support from central banks, and flexibility from regulators should limit bank sector downgrades, for example. The pace and strength of recovery will continue to be critical and volatility is possible, particularly as support schemes are ended. Governments and public finance face the mirror image of this: they will seek to curtail COVID-related outlays without damaging the recovery and mindful of already fractious political environments likely to be exacerbated by economic distress.

- **Changes in life after COVID.** The pandemic has accelerated the already rapid digitalization of the world economy and many changes, such as the shift to greater home working, may endure beyond the end of the acute crisis phase. This poses acute challenges for areas such as retail, commercial real estate, transportation, and mass transit infrastructure. In contrast, some sectors—such as utilities and telecoms—have been largely untouched by COVID, while some, like software, have benefitted.

- **ESG in the spotlight.** Already in 2020 nearly 2,000 rating actions (including outlook changes) were attributable, in part, to an ESG factor. The majority of these changes related to health and safety factors in the context of the social-distancing measures aimed at containing the pandemic. 2021 is also likely to see a greater focus on achieving an environmentally sustainable recovery, with growing awareness of the impact of climate change caused by episodes such as the Australian and Californian wildfires experienced earlier this year. The social challenges posed by COVID-19 such as workforce management and rising inequality are also likely to weigh heavily.

We expect default rates to increase further to high single-digit levels and to remain elevated for some time, rather than exhibiting the more usual pattern of a sharp peak and rapid drop. Extensive government support schemes subsidizing labor, capital, or both, are helping suppress default rates. But this effect will wear off as these are removed and unsustainable capital structures are confronted with a still difficult operating environment. **China’s corporate default trends offer an interesting counterpoint of recovery and default risk.** As economic recovery has gathered pace, the authorities have refocused on the wider risks posed by very high corporate indebtedness and

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1 An obligation rated ‘CCC’ is currently vulnerable to nonpayment and is dependent upon favorable business, financial, and economic conditions for the obligor to meet its financial commitments on the obligation. In the event of adverse business, financial, or economic conditions, the obligor is not likely to have the capacity to meet its financial commitments on the obligation.

We expect the U.S. trailing-12-month speculative-grade corporate default rate to rise to 9% by September 2021 from 6.3% in September 2020. In Europe, we expect the equivalent default rate to rise to 8% by September 2021 from 4.3% in September 2020.
allowed several state-owned enterprises (SOEs) to default on debts. It is not uncommon in crises that the earlier stages of economic recovery are accompanied by a phase of financial distress. But the willingness of governments to end blanket support and refocus on broader risks may well be echoed more widely as the recovery strengthens.

**Key Credit Themes**

**Financing Conditions: Central banks will keep funding costs at record lows through 2023**

Very low funding costs, expected to continue through 2021, are helping governments and corporate issuers cope with the sharp increase in leverage. Central banks have kept liquidity risks at bay for the majority of issuers. However, solvency risks, especially for issuers rated 'B-' and lower, may continue to see low risk appetite, should the trajectory toward economic recovery lengthen. Nevertheless, certain economies, such as China and emerging economies where inflation or other factors may slow the tightening of market conditions, may see reverse trends currently present in developed economies. Central banks will likely support markets in 2021, although this support may move from active (quantitative easing, fiscal and monetary stimulus) to passive (policy guidance and implicit support) as the economy and markets recover. Despite positive news and the present, upbeat investor sentiment, markets will likely remain fragile and reliant on central bank support. Following rapid growth in ESG funding in 2020 (comprising about 18% of the total volume of newly issued bonds), these instruments may pave the way to recovery in a meaningful way in 2021.

**Governments: Time to count the cost?**

Most governments across the world have implemented unprecedented fiscal stimulus to help their economies and cushion the negative impact of the pandemic. While this stimulus varies significantly in size and reach, all sovereigns will likely have to start to design fiscal consolidation strategies at some point in 2021.

We expect overall debt stocks will remain elevated over the medium term, which could be a constraint for growth in the years to come, particularly for middle- and lower-income sovereigns. In 2021, the larger share of the consolidation is likely to be the product of the economic recovery. By 2022, we expect fiscal flows to be similar to pre-pandemic levels, which will help to stabilize debt burden levels. In this context, the low cost of debt buys time, but a combination of sustainable growth and fiscal measures will be needed to put debt ratios on a declining path. Policymakers will have to manage the fine line between the rise in inequalities behind social and political pressures and meaningful structural reform. Agreeing on large and effective stimulus packages was not a simple task. Withdrawing them without jeopardizing economic growth will be a lot harder.
Corporate ratings: Widening gaps

The impact of the pandemic has varied widely, in some cases dramatically so, across corporate industry sectors and we expect this to be an important and continuing theme into 2021. This variation is apparent in revenues, profit margins, liquidity considerations, and debt metrics. It will continue to shape financial trends, competitive positions, and all aspects of the corporate response, notably financial policy, employment, investment, and M&A decisions. Some sectors have been largely immune from COVID-19 (utilities, telecoms), some have benefitted (software, food retail), and others are facing challenges bordering on the existential (shop-centered discretionary retail, leisure and hotels, and airlines).

Revenue and debt-to-EBITDA projections illustrate the wide gap that has opened up between those sectors most affected by COVID-19 and those least affected (see charts 4 and 5). Global revenues for the most-affected sectors are estimated by S&P Global Ratings analysts to have fallen 14% in aggregate, while those for the least affected are projected to contract only 2%. The median debt-to-EBITDA ratio for companies most affected has risen a full turn from 4.4x to 5.4x, versus only half a turn (4.0x to 4.5x) for those least affected. Recovery time varies too. The least affected sectors are

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likely to see revenues and debt metrics return to 2019 levels next year. For the worst-affected, that process will take until 2022, and longer in some cases.

The outlook remains fluid and uncertain, with vaccine availability one key factor and the process of withdrawal of stimulus measures another. We expect funding conditions to remain benign, thanks to central bank support and many government schemes to offer loans, guarantees and job support are likely to be sustained for some time. However, there are limits to the extent these measures can prevent insolvency or forced restructuring for the companies with vulnerable capital structures and most affected by COVID restrictions. Around 12% of rated speculative-grade nonfinancial corporates have had interest cover of less than one for three consecutive years.

Nevertheless, it is important to keep in mind the relative resilience being shown by many sectors which will emerge from the crisis in relatively robust health. While we think ongoing pressures from COVID’s second wave in the northern hemisphere are likely to lead to further downgrades and a continued rise in defaults in the most affected sectors, we do not expect a further broad wave of downgrades akin to what we saw during the early part of the pandemic.

Banks: Facing the toughest test since 2009

The real test to banks’ underlying asset quality will occur in 2021, once support measures start to progressively unwind. The gradual end of fiscal and monetary support measures, and the expiration of debt moratoria and forbearance schemes, will reveal the true impact of the COVID-19 shock on banks’ borrowers. This shock could in some cases be exacerbated by higher corporate leverage and structural changes that the pandemic accelerated—for instance in segments of the property sector. Positively, strengthened bank balance sheets coming into this period of economic shock, proactive loan loss provisioning in 2020, and our expectation that public authorities will tread carefully when withdrawing support, enable the vast majority of banks to face the upcoming asset quality test with confidence.

Beyond 2021, rates that appear set to be lower-for-longer, new forms of competition, the continued need to invest in the digital transformation to meet customers’ evolving preferences and realign their longer-term cost structure, will likely continue to dampen profitability prospects despite regional nuances. ESG factors will also likely gain further prominence for banks and their supervisors, both as a potential source of risk and growth opportunity. These considerations are reflected in about one-third of bank ratings currently on a negative outlook.

Source: S&P Global Ratings.

“COVID-affected” sectors included here are Aerospace & Defense, Autos, Business & Consumer Services, Consumer Products, Hotels Restaurants & Leisure, Media, Oil & Gas, Real Estate, Retailing, Transportation, and Transportation Infrastructure.

Structured Finance: A question of asset class

The broadly improving economic environment anticipated for 2021 means ratings trends for many asset classes are classified as “stable-to-negative”, with at least “somewhat weaker” collateral trends in most of the asset classes in different regions. The primary negative component of the rating trend for certain asset classes reflects two risks:

- Certain industries continuing to be negatively affected by the containment measures due to COVID-19, which then flows through to negatively impact some asset classes; or
- The potentially higher levels of forbearance/payment holidays to be experienced during Q4 2020 and into the first half of 2021, combined with a high percentage of those loans failing to resume their original loan payments once the forbearance/payment holiday period ends, negatively affecting other asset classes.

For 2021, our continued area of focus remains with asset classes most sensitive to the COVID-19 impact, such as commercial mortgage-backed securities (CMBS), collateralized loan obligations (CLO), some residential mortgage-backed securities (RMBS), certain asset-backed securities (ABS), and some Latin American structured finance sectors. For both U.S. and European CMBS, the primary property types most affected are both retail and lodging properties. In addition, we continue to monitor the risks associated with office properties in CMBS, as the recent growth in remote working trends is a negative factor. For U.S. and European CLOs, a key risk for 2021 relates to the possibility of any significant increase in corporate downgrades and corporate loan defaults that result in further negative rating actions in the asset class. The downside risk for global structured finance would be linked to a scenario where forecast economic conditions worsened significantly in 2021 as compared to the current macroeconomic base case, adding pressure to collateral and rating trends for many asset classes.
Top Global Risks

Table 2

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<tr>
<th>Risk level</th>
<th>Forward 12-month trend</th>
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<tbody>
<tr>
<td>Very high</td>
<td>Worsening</td>
</tr>
<tr>
<td>High</td>
<td>Unchanged</td>
</tr>
<tr>
<td>Elevated</td>
<td>Improving</td>
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Risk levels are based on 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.

Corporate solvency risk and new highs in government debt
Fiscal and monetary stimulus have pushed global leverage to new highs (265% of global GDP). For now, ample liquidity and historically low cost of debt buy time for governments and corporates and alleviate debt service. Yet if debt grows faster and income recovers slower than expected, high debt would be harder to manage. As government stimulus recedes, credit pressure will build on corporate borrowers that increased debt with low prospects of full earnings’ recovery by 2022 or later. This could keep default rates higher for longer, fuel credit losses at banks, and weigh on investments and long-term growth. For sovereigns, the impact of high debt on credit risk will depend on policies to restore growth, fiscal and monetary flexibility and exposure to shifts in market conditions.

Extended COVID measures and transition to post-COVID policies
The next four to six months will stay difficult. Possible new waves of COVID-19 cases, particularly in the northern hemisphere, would extend containment measures and risk delaying economic recovery, with significant credit implications in some industries. As well as the pace and timing of recovery, the overall economic cost and credit implications will depend on an effective transition to post-COVID policies: less supportive fiscal packages could hurt employment and the solvency of small or more exposed businesses. News that several vaccines have proved efficient in late-stage trials offer optimism for H2 2021. Still, fabrication and distribution obstacles, and anti-vax sentiment in some countries, point to an only gradual rollout of vaccines, medical treatments, and testing.

Lasting credit damage for some emerging markets
Many emerging markets are struggling to contain the pandemic or face a resurgence of cases. This could undermine a relevant season for tourism and exacerbate the economic cost. A weaker recovery could see ailing corporations forced to more layoffs with the consequent spillover for households. Contagion could also extend to banks as credit forbearance and fiscal stimulus are phased out. Overall, a slower recovery will be tough for many EMs dealing with rising fiscal pressures and with little room to provide additional fiscal or monetary stimulus without hurting credit quality. Financing conditions continue improving in a low yield environment, but countries dependent on external financing remain exposed to volatile capital flows and fragile investor sentiment.

ESG: Cyber, climate, and social risks
Climate change, social unrest, and technology risks could affect issuers’ mid- to long-term operations. The transition to net-zero emissions remains a key priority for policymakers, posing risks and opportunities to the global economy. Risks include governments prioritizing near-term economic recovery and delaying environmental regulation. The economic consequences of the pandemic have raised socioeconomic inequalities. Job losses hit low-income workers harder, widening the wealth gap in the largest economies and increasing poverty in low-income economies, heightening risks to political and social stability. Accelerated digitization has intensified risks of technology obsolescence for traditional businesses, and cyberattacks on institutions.

Spillover from economic nationalism and geopolitical tensions
Amplified geopolitical tensions and economic nationalism amid the pandemic weigh on global trade and could prompt long-term structural shifts in global supply chains. Under President-elect Biden, the U.S.–China strategic confrontation could change tone but will, unlikely change direction. Tensions between the two biggest economies look set to persist, especially in technology, intellectual property, and market access. The “dual circulation” strategy recently announced by China also indicates its determination to rely less on foreign markets and technology. Escalation in tensions would further dampen cross-border investment, hit supply chains, and restrict access to intellectual property and markets. Another strain is the tough U.K.-EU negotiation on a free trade agreement.

Source: S&P Global Ratings.
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S&P Global Ratings believes there remains a high degree of uncertainty about the evolution of the coronavirus pandemic. Reports that at least one experimental vaccine is highly effective and might gain initial approval by the end of the year are promising, but this is merely the first step toward a return to social and economic normality; equally critical is the widespread availability of effective immunization, which could come by the middle of next year. We use 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.

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