S&P Global Ratings

Regional Credit Conditions Chair

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Credit Conditions Emerging Markets Q4 2021:

Pandemic Scars Will Linger As New Risks Emerge

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Key Takeaways

- Overall: Improvement in credit conditions across key emerging markets (EMs) could be plateauing over the coming months, as pre-existing weaknesses and increasing post-pandemic challenges slow economic recovery and hinder business conditions. On the bright side, many EM economies have returned to their pre-pandemic levels and negative rating bias has decreased. Vaccination has accelerated in most key EMs, while recent virus outbreaks haven't been as harmful to economic activity, given that private sector's consumption and investment patterns have been adapting to the pandemic.
- Risks: Downside risks for EMs are significant. The effects of the pandemic will to be long lasting as governments maneuver to consolidate their finances and corporations to improve their fundamentals. Accelerating inflation in many key EMs could undermine economic recovery if it persists. China's policy shift could imply lower GDP growth with spillover effects regionally and globally. Meanwhile, any shock to financing conditions, driven for example by faster-than-expected U.S. monetary tightening, could result in defaults and bankruptcies, especially among lower rated entities.
- Credit: Negative rating bias (the percentage of ratings with negative outlooks or placed on CreditWatch negative) followed a downward trend across most EMs, but remains high in EM Asia where pandemic effects linger and weigh on issuers' credit quality. While this is a sign that credit conditions have improved in many cases, negative outlooks led to lower ratings.

(Editor's Note: S&P Global Ratings' Credit Conditions Committees meet quarterly to review macroeconomic conditions in each of four regions [Asia-Pacific, EMs, North America, and Europe]. Discussions center on identifying credit risks and their potential ratings impact in various asset classes, as well as borrowing and lending trends for businesses and consumers. This commentary reflects views discussed in the EMs committee on September 22, 2021)

Contents

Regional Credit Conditions	3
Macroeconomic Outlook	5
Financing Conditions	11
Sector Trends	13
Appendix 1:	
Economic Forecasts	26

Top EM Risks

Table 1

Long-Lasting Effects Of COVID-19, Posing Persistent Challenges For Highly-Indebted Governments And Low Rated Corporations

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

The Delta variant didn't have as much of an impact on domestic activity as we expected, and exports expanded rapidly. Mobility is close to, or above pre-pandemic levels, suggesting a limited upside from further re-openings. However, economic recovery is creating new difficulties, including inflationary pressures and the potential for higher interest rates domestically and abroad. Furthermore, as economy rebounds, governments will need to figure out the proper timing for withdrawing stimulus and support measures, such as debt forbearance. This in turn could expose heavily-indebted corporations to additional pressures and the risks of downgrades and defaults--despite the currently improving conditions--especially among entities in the 'B' and 'CCC' rating categories.

Inflation continues accelerating in many EMs, due to higher fuel and food prices, and supply-chain disruptions amid a stronger economic rebound. Risk of an extended period of higher inflation in some EMs remains, especially if supply-chain disruption prevails. Prolonged price pressures from supply-chain problems can spill over to core prices in countries with weakly anchored inflation expectations.

EM sovereign debt has rapidly increased following efforts to contain the pandemic shock. Now, considerable fiscal consolidation is necessary to stabilize government debt levels. There are substantial risks in doing so, including weaker real and nominal GDP growth due to extended pandemic effects, premature stimulus withdrawals (fiscal and monetary), failure to cut spending due to political resistance, and materializing contingent liabilities. In our view, failure to stabilize debt will probably weaken credit quality.

Risk Of A Rapid Adjustment In U.S. Yields Could Lead To Volatile Financing Conditions And Narrower Access To Credit Markets

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

Fed Chairman Powell signaled that the Fed is ready to announce tapering in bond purchases in early November. Markets have taken it in stride so far, unlike the 2013 taper tantrum. Perhaps it is because the mechanical effects of reduction in asset purchases will be blunted by significant declines in Treasury issuance and agency mortgage-backed securities (MBS) issuance. Still, concerns about a faster than expected normalization in U.S. monetary policy rate remain intact. U.S inflationary pressures likely peaked in summer but there is a fair amount of uncertainty on when the supply-chain disruptions, surging maritime costs, and labor shortage related price-pressures fade. If inflation outlook stays near 3% for longer than currently anticipated by the Fed, it could blink in fear of inflation expectations unmooring. We now pencil in December 2022 for rate lift-off. A rapid and volatile market repricing would especially pressure corporate credit quality at the lower end of the rating scale and EMs. The EMs most at risk are the usual suspects; those that heavily rely on foreign funding and large external and/or fiscal imbalances.

The Prevalence Of COVID-19 Across Key EMs, Slow Vaccination Progress, And New Variants Dampening Economic Recovery

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

Vaccination has accelerated in most key EMs. However, many remain far away from widespread immunity thresholds (70%-80% of population fully vaccinated), especially in EM Asia and Sub-Saharan Africa. What was once a matter of vaccine availability seems to have transitioned in slower vaccination rates, which could be a result of issues with logistics, and in some cases, vaccination reluctance, which could be harder to tackle. While economies have adapted to the pandemic, the risk of one-off lockdowns remains elevated, and the associated uncertainty is curtailing consumption and investment. Further progress in vaccination is necessary to prevent "on-and-off" lockdown measures and return to operating at full capacity.

Shifting China Policy Stance Cloud Credit And Growth Trajectories

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

China's policy stances of "dual circulation" (reduced dependence on foreign technology and economies) and "common prosperity" (reducing income disparity and aligning social values) imply an increased tolerance for lower GDP and private sector income growth. They hint at a widening crackdown on private-sector enterprises that tracks the state's squeeze on the technology, real estate, gaming, and education sectors. Efforts to curb excess debt and less-productive investments have contributed to credit stress for leveraged issuers such as Evergrande and China Huarong Asset Management. Positively, targeting lower GDP growth and curbs on overborrowing may moderate the corporate debt overhang. However, the manner in which large corporate failures are handled may have unintended consequences, such as contagion fueled by drops in confidence. Meanwhile, China's enforcement of environmental regulations leads to electricity power cuts--hitting both manufacturing and supply chains. Separately, any further weakening of U.S.-China relations would constrain cross-border investments, and raise the cost of trade, intellectual property, investments, and financial transactions between these economies. Naturally, policy and economic developments in China affect entities reliant on the country for exports or finance (e.g. emerging markets) and imports (e.g. component parts).

Wide Income Inequality, Increasing Poverty Levels, And Poor Access To Health Services Are Spurring Social Unrest

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

The risk of social unrest in EMs will remain high, undermining policy predictability. Social unrest in Colombia over a tax proposal and in South Africa after the arrest of former president Jacob Zuma underscore a wider issue across several EMs. The pandemic hit the middle- and lower-income households the hardest, and income inequality has worsened. Fiscal adjustments will be necessary in several EMs to pay for the COVID-19 stimulus bills. Additionally, in many cases, households hit the worst during the pandemic may have to pay a high proportion of that bill, creating challenging social and political dynamics, and ultimately, increasing policy uncertainty.

Sources: S&P Global Ratings.

* Risk levels may be classified as very low, moderate, elevated, high, or very high, and are evaluated by considering both the likelihood and systemic impact of such an event occurring over the next one to two years. Typically, these risks are not factored into our base case rating assumptions unless the risk level is very high.

** Risk trend reflects our current view on whether the risk level could increase or decrease over the next 12 months.

Regional Credit Conditions

Post-Pandemic Challenges Await

Improvement in credit conditions across key EMs could be plateauing over the coming months, as pre-existing weaknesses and increasing post-pandemic challenges slow economic recovery and hinder business conditions. On the bright side, many EM economies have returned to their pre-pandemic levels, negative rating bias has decreased--in some cases below historical levels—(see chart 11) and progress has been made across most key EMs in adapting to the pandemic, rather than to controlling the outbreaks. There's divergence though, given stricter measures in EM Asia to contain outbreaks, causing setbacks to economic recovery, while vaccination progress and resumption of activity in EM EMEA and LatAm, despite new waves, have resulted in better-than-expected economic performance.

Recovery has come at a high price for EMs, not only in the death toll, but also in the sovereigns' greater debt burdens to deliver unprecedented fiscal and monetary stimulus. We expect the effects of the pandemic to be long-lasting for many key EMs and for risks to remain high as governments maneuver to consolidate their finances and corporations to improve their fundamentals. Meanwhile, any shock to financing conditions could result in defaults and bankruptcies, especially among lower rated entities.

Vaccination has accelerated in most key EMs, and it would take them a median of four months to reach widespread immunity levels. This pace is faster than our previous expectations. Moreover, recent virus outbreaks haven't been as harmful to economic activity, given that the private sector has been learning to live with the virus, while consumption and investment patterns have been adapting accordingly. Nevertheless, the pandemic-related downside risks remain elevated, in our view, because in many EMs (especially in Sub-Saharan Africa and EM Asia), vaccination is lagging and, in some countries,, the percentage of adults who don’t want to vaccinate is high. This could make it hard to reach widespread immunity, resume economic activity, and restore consumer confidence. Countries with low vaccination levels remain exposed to new virus variants and renewed restrictions on activities, which could impair their economic recovery.

The Chinese government's policy stance of "dual circulation" (reduced dependence on foreign technology and economies) and "common prosperity" (reducing income disparity and aligning social values) implies an increased tolerance for lower GDP and private-sector income growth. If the new policy direction results in slower growth over the short run, it could be especially harmful for China’s key trading partners and commodity exporters in EMs. Furthermore, the recent downfall of Evergrande and China Huarong Asset Management, resulting from regulatory changes and policy implementation, could cause temporary market dislocations, leading to heightened volatility and restrict market access among EM issuers at the lower rated spectrum.

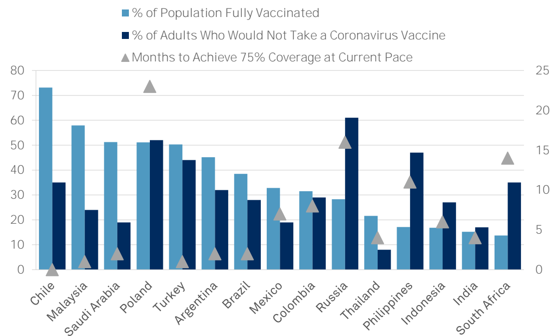
Inflation continues rising in many EMs, due to higher fuel and food prices, and supply-chain disruptions interacting with a stronger economic rebound. Risk of an extended period of higher inflation in some EMs remains, as prolonged price pressures from supply-chain problems can spill over to core prices in countries with weakly anchored inflation expectations. Persistently high inflation could erode households' disposable income, profit margins for corporations unable to transfer costs to their customers and increase debt costs for all borrowers. At this point, many EM central banks confront the dilemma between anchoring inflation expectations and supporting short-term growth. Already, some central banks in key EMs have raised their interest rates (see chart 2), and we expect this trend to continue, except in EM Asia where inflation remains muted.

Overall, negative rating bias (the percentage of ratings with negative outlooks or placed on CreditWatch negative) has receded in most EMs, except for entities in EM Asia (excluding China) where it remains above historical averages (see chart 11). While this is a sign that credit conditions

have improved, in many cases negative outlooks led to downgrades. Rating distribution across EMs (excluding China) has worsen with investment grade issuers falling 11.4% as Sept. 2021 vs year-end 2019, at the same time high yield issuers have increased and now represent 61.8% of the mix, notably 'CCC' rated credits are up to 8% of the total from 3% at the end of 2019 (see chart 3). In other words, the panorama looks more stable for rated entities, but the pandemic fallout is now reflected in weaker fundamentals in many sectors. This also means that many entities will be more vulnerable to economic setbacks or worsening financing conditions going forward.

Chart 1

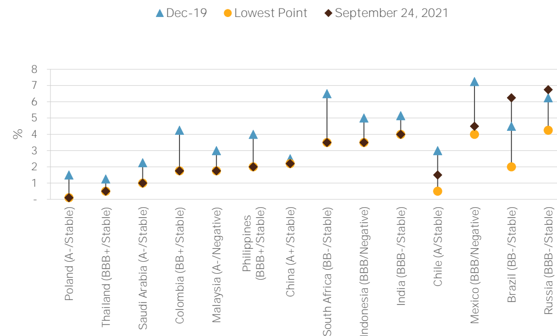
Vaccination Accelerated, Downside Risks Are Relevant



Source: OWID and S&P Global Ratings.

Chart 2

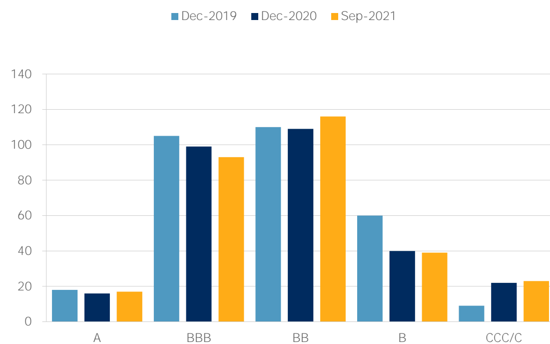
Key EM Policy Rates, Hawks And Doves



Source: Central banks and monetary authorities from respective countries. Sovereign ratings as of Sept. 27, 2021.

Chart 3

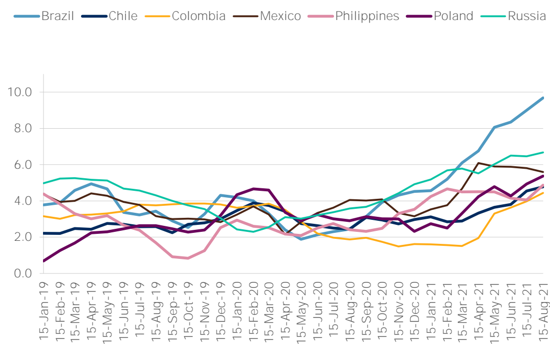
EM Rating Distribution (Excluding China)



Data as of Sept. 21, 2021. Source: S&P Global Ratings

Chart 4

Key EMs With Inflation Running Above Target



Note: Running above upper threshold of inflation target. Excluding Argentina and Turkey. Source: Datastream.

Macroeconomic Conditions

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

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Vaccination Progress And Policy Decisions Remain Key To Growth

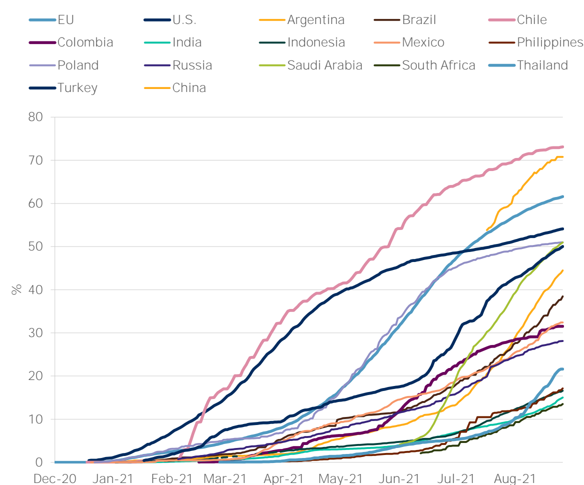
- EM economies are benefiting from a stronger-than-expected first half, accelerating vaccination rollouts, and lower tolerance for renewed restrictions on economic activity.
- As a result, we have raised our 2021 real GDP growth forecast for EMs (excluding China and India) to 4.8% from 4.6% previously. We cut our 2021 growth forecasts for EM Asia, but upgraded forecasts for EM EMEA and LatAm.
- Risks to our growth outlook are on the downside and include a delayed exit from the pandemic and bumpy transition from recovery-related, ultra-accommodative policies to generally tighter steady-state expansion policies.

The pace of vaccine rollout has accelerated in core EMs since our last Credit Conditions Committee meeting (in June). Nevertheless, EMs continue to lag advanced economies in vaccination, most are well short of the so-called herd immunity level of 70%-80%, and wide variations remain across regions--specifically, countries that we cover in EM EMEA and LatAm are generally ahead of those in EM Asia (see chart 5).

Because of their faster progress on the vaccination front, just as virus-related restrictions eased, recoveries across EM EMEA and LatAm--as measured by inflation-adjusted GDP (or real GDP)--were stronger in the second quarter than we had expected. Exports, especially commodity-related, expanded rapidly, and the services sectors that are usually vulnerable to the pandemic performed better than expected under the circumstances. The early signs for the third quarter are encouraging as mobility measures continue to move up (see chart 6) with low tolerance for renewed restrictions on economic activity.

Chart 5

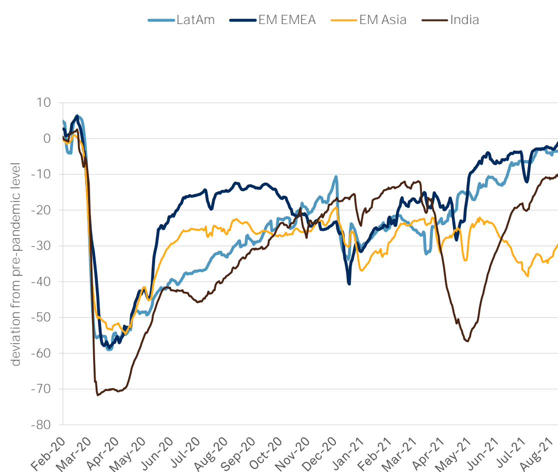
Share Of Population Fully Vaccinated



Data as of Sept. 21, 2021 Source: OWID.

Chart 6

Mobility Back To Pre-Pandemic Levels In EM EMEA And LatAm



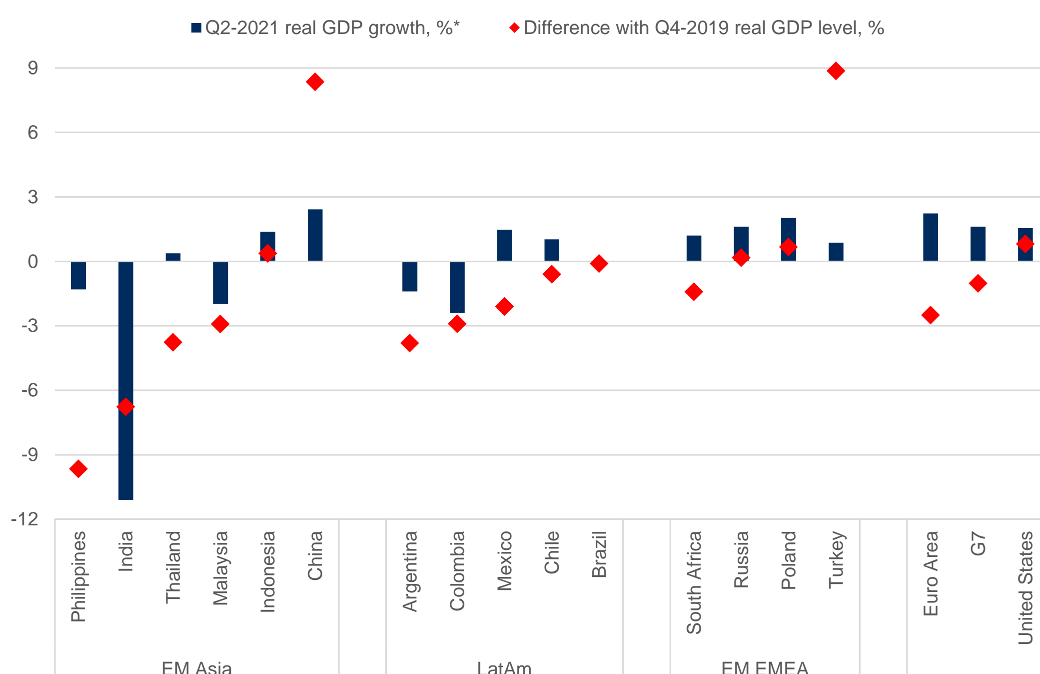
Note: The index is constructed as equally-weighted index of retail and recreation, transit, and workplaces. Seven-day moving averages shown. The baseline is the median value, for the corresponding day of the week, during the five-week period Jan. 3 – Feb. 6, 2020. Regional aggregates are based on PPP weights. Source: Google LLC "Google COVID-19 Community Mobility Reports", IMF, S&P Global Ratings. Data as of Sept. 14, 2021.

On the other hand, even as EM Asia's economic growth was better than expected in the second quarter, the Delta variant's rise in the third quarter tempered recovery to a greater degree than we had expected. The slow vaccine rollouts in the region, combined with low tolerance for virus spread, led to renewed restrictions on activity. Only recently has the spread of virus come somewhat under control, and mobility measures have started to normalize.

All this means is that recovery is delayed, not derailed, in EM Asia. In the near term, gains from the reopenings will be stronger in EM Asia than in other regions, which should help the lagging EM Asian economies reach their pre-pandemic real GDP levels by the beginning of next year. Most EM EMEA economies have returned to their pre-pandemic level of activity, because they avoided renewed restrictions in the past three months. The median pre-pandemic real GDP gap for LatAm as of the second quarter is about 2% (see chart 7).

Chart 7

EM-EMEA Is Now Above Pre-Pandemic Levels, And Latin America Is Not Far Behind; Southeast Asia Lags



*Seasonally adjusted quarter over quarter. Note: Argentina Q2 is an estimate based on the monthly economic activity index.
Source: Haver, OECD, Oxford Economics, and S&P Global Ratings.

Inflation continues to rise in many EMs because of higher fuel and food prices, and supply-chain disruptions interacting with a stronger economic rebound. Unlike in advanced economies, the food's share of the consumer price basket is higher in EMs. The U.N. FAO Food Price Index was up 33% in August from the same period last year, with little sign of softening in the near term. At the same time, exporters and factories are struggling with the impact of supply-chain disruption, shortages, shipping delays, and chronic port congestions.

Central banks in Brazil, Russia, Mexico, and Chile (just recently) have raised policy rates to tighten financial conditions to rein in inflationary pressures, while more countries in LatAm and EM EMEA are likely to do so as well, sooner than previously expected, to keep inflation expectations anchored (Turkey is an outlier, with a surprise 100 basis-point [bp] cut just recently). In contrast, inflation pressures in EM Asia remain muted, outside of the Philippines. Inflation in India has eased somewhat since our last publication (on lower food price inflation) but remains near the upper end of the tolerance range at 6%. Except for a few countries (China, Saudi Arabia, and Indonesia), the majority of the countries in EMs are running real interest rates lower than their 10-year averages, by more than 100 bps at the low end (Thailand and Malaysia) to almost 600 bps (Brazil). Monetary

stance is tighter than it seems, once adjusted for one-off effects and base-effects influencing current inflation.

We have raised our EM-14 (excluding China and India) real GDP growth forecast for 2021, given that a downward revision for EM Asia was more than offset by upward revisions for LatAm and EM EMEA (see tables 2 and 3). Specifically, we lowered our growth forecast for EM Asia by 0.4 percentage points (ppt) to 7.6%, while we revised it for LatAm and EM EMEA up by 0.5 ppt and 0.7 ppt, respectively, to 6.2% and 4.8%. Our forecasts for 2022 are unchanged at 3.6%. Forecasts for 2023 and 2024 also remain broadly unchanged, averaging 3.1%. As of the second quarter of 2021, 10 out of 16 EMs (EM-16, which includes China and India) were short of pre-pandemic levels. We forecast that all 16 will pass their respective pre-pandemic peaks by the end of second quarter of 2022.

Table 2

Real GDP %

	2018	2019	2020	2021	2022	2023	2024
LatAm	1.5	0.7	(6.6)	6.2	2.4	2.3	2.3
EM-EMEA	3.0	1.6	(2.3)	4.8	3.2	2.4	2.3
EM-Asia	6.5	5.3	(1.1)	7.6	5.8	5.2	5.2
EM-16	5.2	4.0	(2.0)	6.9	4.9	4.4	4.3
EM-14	3.1	2.1	(4.3)	4.7	3.6	3.2	3.0
EM Ex. China	4.1	2.7	(5.2)	6.2	4.8	3.9	4.0

Source: Oxford Economics; F--S&P Global Ratings forecast. Note: GDP aggregates are based on GDP PPP Weights. EM-14 excludes China and India. For India, 2019 = FY 2019 / 20, 2020 = FY 2020 / 21, 2021 = FY 2021 / 22, 2022 = FY 2022 / 23, 2023 = FY 2023 / 24.

Table 3

Real GDP Changes From June Baseline (%)

	2021f	2022f
LatAm	0.5	(0.1)
EM-EMEA	0.7	0.1
EM-Asia	(0.4)	(0.1)
EM-16	(0.1)	(0.1)
EM-14	0.1	(0.0)
EM Ex. China	0.1	(0.1)

Source: Oxford Economics; F--S&P Global Ratings forecast. Note: GDP aggregates are based on GDP PPP Weights. EM-14 excludes China and India. For India, 2019 = FY 2019 / 20, 2020 = FY 2020 / 21, 2021 = FY 2021 / 22, 2022 = FY 2022 / 23, 2023 = FY 2023 / 24.

LatAm (Argentina, Brazil, Chile, Colombia, Mexico, And Peru)

Growth in LatAm was generally slightly better than expected over the last quarter. This puts our 2021 GDP growth roughly 0.5 ppt above our previous projection to just over 6% for these five LatAm countries. The main reason was robust activity in the services sector, which has been more resilient to pandemic-related developments. Lockdowns are having less of an impact on GDP in the region. However, the same is the case for reopenings--most sectors that still have social-distance restrictions in place are generally account for a small share of GDP. Therefore, we expect the region's GDP growth to reach the historical trend of 2.5% on average. We expect growth slowing to about 2.4% in 2022. Overall, the region will reach its pre-pandemic GDP level in early 2022.

The upside surprises to activity have also increased inflation expectations, which for most of the region remain above the central bank targets, not only for the end of 2021 but also for 2022. LatAm central banks have already responded by starting to increase interest rates, and will continue to do so in the coming months. Net monetary tightening, combined with net fiscal tightening (removal of stimulus), are main reasons why we expect growth to slower in 2022 than in 2021. A heavy electoral calendar between the end of 2021 and 2022, amid high unemployment and social unrest, will likely limit investment until policy predictability rises – also a key factor underpinning our expectation for slower growth next year.

To read our full report on Latin America, click HERE.

EM EMEA (Poland, Russia, Saudi Arabia, South Africa, And Turkey)

Emerging EMEA economies posted solid growth numbers in the second quarter, surprising again on the upside, which has prompted us to revise upwards our 2021 growth forecast for Poland, Russia, South Africa, and Turkey. Taking into account stronger-than-expected consumption and exports performance in most of these economies, we now forecast regional GDP growth to average 4.8% this year, up from 4.1% previously. Our regional 2022 growth forecast is slightly lower than before at 3.2%. Emerging EMEA economies are ahead in the recovery, with output in Poland and Russia back to their pre-pandemic level in the second quarter, and Turkey's real GDP exceeding this level by 9%. South Africa's gap with its pre-pandemic activity level has narrowed faster than expected; however, there's still significant slack in the economy.

Third-quarter growth outcomes are looking mixed, in part due to the diverging trends in pandemic's trajectory. Growth momentum has remained strong in Poland, but it slowed in Russia. In South Africa, the third COVID wave and riots in July weighed on the third-quarter growth, but the impact on activity appears to be temporary. A somewhat better-than-expected summer tourism season boosted Turkey's economy and foreign currency revenues.

Despite the variation in the pandemic picture, EM EMEA economies are finishing the quarter with the mobility levels that are close to, or above, the pre-pandemic level. This bodes well for consumption in the fourth quarter, but also suggests that in the coming quarters, economic gains from further reopenings will be smaller than before. The domestic activity pace will be determined by how rapidly confidence returns, which is linked to a progress in vaccination, as well as policy settings.

Exports expanded rapidly, both in volume and value, thanks to robust global demand and high commodity prices. Trade will continue to support growth in the region in the coming quarters, but is set to moderate, as global spending shifts away from goods towards services, and commodity prices ease.

Inflation continues to rise in emerging EMEA economies, drifting further away from the central banks' targets, as supply-side pressures are interacting with a stronger economic rebound. Elevated core inflation, higher inflation expectations, and in some cases tightening labor market add pressure on central banks to act.

To read our full report on EM EMEA, click HERE.

EM Asia (India, Indonesia, Malaysia, The Philippines, And Thailand)

Growth outlooks in emerging Asia are now stabilizing following severe and prolonged COVID-19 waves, as the region gradually ramps up the vaccination program and moves towards greater tolerance of ongoing COVID-19 cases. Indonesia has been responding to COVID-19 waves with lighter lockdowns than those during the early pandemic, while Malaysia and Thailand have recently moved to ease restrictions even though COVID-19 cases are not fully contained. The Indian economy is now recovering following a downturn due to a severe COVID-19 escalation in April and May.

Severe pandemic waves hit economic activity hard in Southeast Asia, which led us to lower our 2021 growth forecasts for Indonesia, Malaysia, the Philippines, and Thailand to 3.1% from 4.3%. On

the other hand, we raised our 2022 forecast to 5.7% from 5.6% earlier (see “Pandemic is Disrupting 2021 Growth Outlooks in Southeast Asia”, August 17, 2021).

Gradual reopening of the economy will support growth in emerging Asia. However, balance sheet costs have risen following fresh hits to economic activity as households drew down on savings and the informal and micro and small enterprise sectors faced closures. These costs will take time to unwind, and we expect economic activity for the region to be 11% below the pre-COVID level by the end of our forecast horizon.

While domestic demand recovers gradually, international trade has been preventing growth from slowing more sharply. Trade volumes and values are noticeably higher than pre-pandemic levels. However, there's a sequential slowdown in trade now underway, which means domestic demand will have to do more of the lifting to support growth.

Inflation in EM Asia remains broadly muted, as domestic core price pressures are subdued. Weak domestic demand and lockdowns have kept a lid on core prices, which have in turn held back overall inflation. Energy price inflation is increasing at double-digit rates. Food prices, which have a greater weight in the overall inflation basket, have been steadier, although there are recent upticks in Indonesia and the Philippines. Overall, this means we expect monetary policy to remain accommodative in the region until mid-2022.

To read our full report on APAC, click HERE.

Risks To Our Baseline

Even as economic activity in EMs ramps up, downside risks to our growth forecasts from COVID-19 can’t be brushed off just yet--in particular, worsening fatalities could reverse some reopening trends. At the same time, across EMs (and globally, for that matter), manufacturers and exporters are facing headwinds from supply-chain disruption, and surging freight and maritime costs. The risk is rising that ironing-out supply-side wrinkles may take longer than the first half of next year.

Additionally, there are risks related to domestic fiscal and monetary policy transitioning to the post-COVID-19 expansion. First, in many EMs, fiscal positions have weakened significantly during the pandemic. In some cases, fiscal weakness pre-dated the pandemic. It will be key for those EM governments to put their fiscal accounts on credible, sustainable paths, including stabilizing or reducing key debt ratios, although for most economies, a moderate fiscal adjustment may be sufficient to stabilize current ratios. Removing stimulus measures is a challenging task when the recovery is still fragile with elevated levels of unemployment, and growth deceleration could prove sharper than expected.

Second, monetary authorities will have to walk a fine line in anchoring inflation expectations while supporting short-term growth. Core inflation in countries in LatAm and EM EMEA (except South Africa) is running above central bank targets (target bands in some), and inflation expectations are rising in some, putting pressure on central banks to raise rates more aggressively than expected. Even in EM Asia, where inflation remains fairly muted (except for the Philippines where it's above central bank target), central banks in the region are wary of easing in fear of capital outflows, given that the Fed is getting closer to tapering quantitative easing, which is the first step in normalizing monetary policy.

While not our baseline forecast, it is worth emphasizing that there is an outsize risk from U.S. policy normalization that may happen earlier than what is currently priced in the market (December 2022) (see more in "Economic Outlook U.S. Q4 2021: The Rocket Is Leveling Off," Sept. 23, 2021). The resulting repricing could cause market volatility, including widening spreads and tightening access among higher-risk borrowers to credit markets, and asset price volatility and downward adjustments, with knock-on effects on spending, and ultimately, employment and growth. By standard measure, EM foreign-exchange (FX) valuations are currently cheap, and current account positions are generally positive. Rising commodity prices, and subsequently beneficial terms of trade, haven't strengthened EM currencies in the same manner as in the past (Brazil, Colombia, and Russia). But that may change, although for a different reason, as a renewed steepening in yield

curves in the U.S. and other advanced economies would be a less favorable backdrop for EM currencies and credit.

Last, but not the least, there's China. If its new policy direction (towards "dual circulation" and "common prosperity") results in a substantially slower trend growth, given China's established position in propelling global growth, the impact will be felt by a wide swathe of EM trading partners as well, and especially, commodity exporting ones.

These factors point to a possibly bumpy transition from ultra-low rates and easy financing conditions to the post-pandemic state.

Read our latest Emerging Markets Economic Outlook HERE

Financing Conditions

Broadly Favorable, Inflationary Pressures Remain

EMs' financing conditions remain broadly supportive, with funding costs kept at bay. Although some central banks in EM EMEA and LatAm have continued raising rates, most EMs' interest rates remain below their pre-pandemic levels.

Secondary markets saw gradual narrowing in risk premia with spreads edging lower across EMs in August. Risk aversion continues to persist especially at the lower end of the credit spectrum; on the other hand, risk appetite for investment-grade issues remains strong. In EM Asia, the bailout of the Huarong Asset Management calmed down the market. However, high-yield credit spreads saw a spike in September following Chinese property giant Evergrande's liquidity shock. We expect investors to remain selective and adverse to lower-rated issuers over the coming quarters.

Some EMs continue to experience significant inflation pressures, which led respective central banks to tighten policy. So far, this hasn't been a widespread phenomenon. Nevertheless, the rising inflation risk remains a key concern for EMs. Once interest rates experience a sudden and sharp re-pricing, this, along with already tenuous investor sentiment, could heighten refinancing risk.

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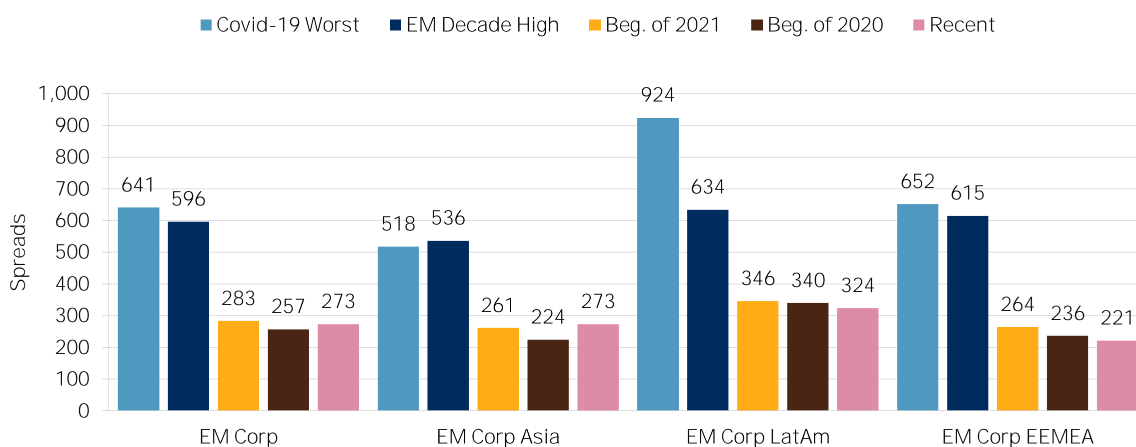
Chart 8

EM Spreads By Region (bps)

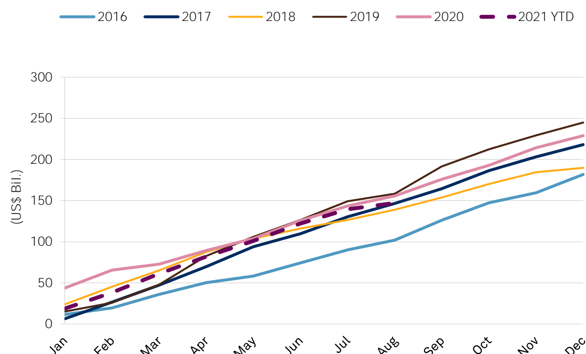


Note: Data as of Aug. 31, 2021 for EMs. Source: S&P Global Ratings Research, Thomson Reuters, ICE Data Indices, Federal Reserve Bank of St. Louis.

The 2021 year-to-date EM corporate (financial and nonfinancial) bond issuances reached more than $1.2 trillion (through August 31), on pace with that of last year. While EM Asian issuances, led mostly by China, has held up, those in EM EMEA and LatAm saw a sharp drop in August. However, this could be a temporary dip related to the summer vacation season. The rising inflation pressure could cause tighter credit conditions, which could slow the issuance pace again.

Chart 9

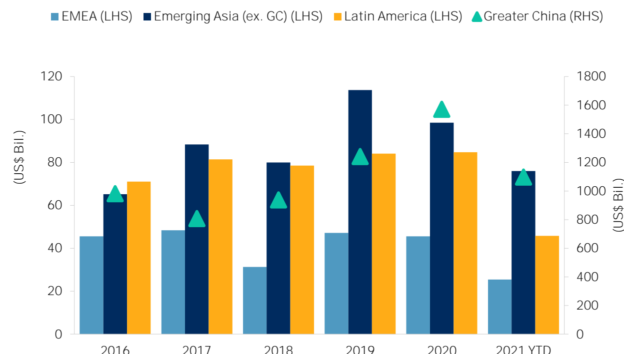
EM Cumulative Corporate Bond Issuances



Excluding Greater China. Data as of Aug. 31, 2021. Data including NR (not rated) and both financial and non-financial entities. Source: S&P Global Ratings Research, Thomson Reuters.

Chart 10

EM Regional Bond Issuances

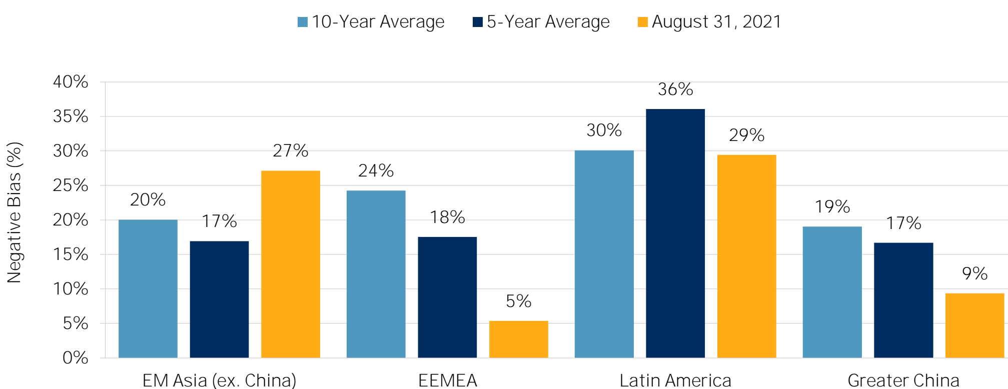


Data as of Aug. 31, 2021. for both Financials and Non-Financials Source: S&P Global Ratings Research; Thomson Reuters.

Based on where the business is operated, there were 14 corporate defaults across EMs for 2021 year to date (through September 8). As a comparison, this year's global corporate default tally (based on where the business is located) has risen to 59 (through September 8). Globally, at this point in 2020, there were 169 defaults in the year, compared with 59 in 2018 and 76 in 2019 (see "The 2021 Global Corporate Default Tally Remains At 59," published on RatingsDirect on Sept. 9, 2021).

Chart 11

EM Downgrade Potential Varied Across Regions



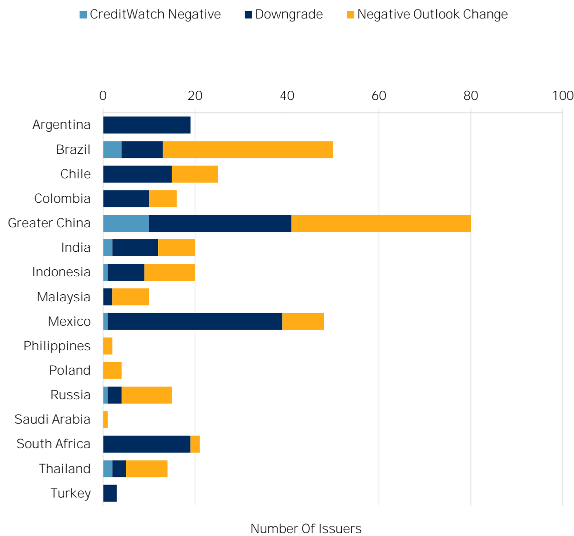
Note: Data as of Aug. 31, 2021 and excluding sovereigns. Source: S&P Global Ratings Research. Latin America: Argentina, Brazil, Chile, Colombia, Mexico. Emerging Asia: India, Indonesia, Malaysia, Thailand, Philippines. EEMEA: Poland, Russia, Saudi Arabia, South Africa, Turkey. Greater China: China, Hong Kong (SAR), Macao (SAR), the market of Taiwan, and Red Chip companies.

S&P Global Ratings

Sector Trends

Chart 12

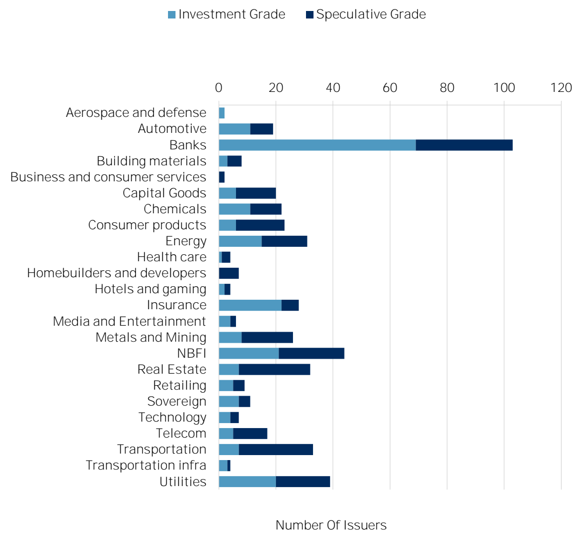
Rating Actions In EMs



Source: S&P Global Ratings. Data is from Feb. 3, 2020, to June 18, 2021.

Chart 13

Rating Actions In EMs By Sector



Source: S&P Global Ratings. Data is from Feb. 3, 2020, to June 18, 2021.

Sovereigns

EM Asia

- New infections have surged due to the Delta variant.
- New virus strains and fading vaccine efficacy could raise risks.
- Supply chain bottlenecks and volatile financial conditions could slow recovery of metrics.

Supply and logistical risks to exports. A shortage of semiconductor chips and bottlenecks in container shipping have disrupted production and raised manufacturers' costs.

Inflation rates in Europe and the U.S. have picked up. Consumer prices rose quickly in 2021 in major advanced economies. Policymakers continue to believe the increases to be temporary, but pressures on policy rates could increase if the higher inflation rates prove persistent.

Delta variant spreads. The spread of the highly infectious Delta variant has caused rebounds in infection rates, even in places where vaccination rates are relatively high. This has forced some EM Asian governments to tighten movement restrictions.

COVID Variants And Potential For Capital Swings Remain Key Risks

COVID-19 variants. If mutations outpace vaccine rollouts and infection rates rebound in the region, sovereign credit metrics could weaken significantly.

Sudden capital swings. Deterioration in investor sentiment towards EMs could result in swift capital outflows. In lower-rated sovereigns dependent on imported sources of energy, higher oil prices would weaken their external balances and exacerbate capital outflows.

Dampened manufacturing recovery may weigh on growth and fiscal recovery. Rising component and commodity prices, as well as shipping costs, could hobble production recovery. Shortages of semiconductors have also caused some auto manufacturers to temporarily halt production. If

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these trends persist and government support tapers off, weaker demand may intensify pressures on manufacturers and exports out of EM Asia.

Geopolitical developments that could disrupt momentum. U.S.-China tensions are increasingly being played out with displays of military prowess. Accidental contacts that escalate these tensions could spill over into trade and financial interactions.

Prolonged pandemic possible if vaccines become less effective. Poor efficacy of vaccines against potential new variants of COVID-19 or fading vaccine efficacy against existing variants presents risks that could prolong the pandemic.

LatAm

Longstanding Structural Weakness Could Undermine Sovereign Rating Factors Recovery

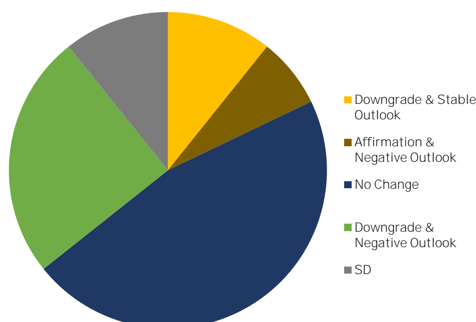
The pandemic's effect on sovereign ratings and its economic fallout have been acute in LatAm and the Caribbean. Of the 28 EM sovereigns in the region, we have downgraded 10 and assigned a negative outlook on 7 of them since the beginning of the pandemic. Only 13 sovereigns retain the same rating and outlook as prior to the pandemic. Three regional sovereigns are in selective default (SD): Venezuela, Suriname, and Belize.

The pattern of deterioration in sovereign credit ratings stems from changes we made in the scores of rating factors since the start of the pandemic. We rate sovereigns based on five factors: institutional, economic, external, fiscal, and monetary. We assess each of the factors on a six-point numerical scale from '1' (the strongest) to '3' or '4' (neutral) to '6' (the weakest).

We have revised our fiscal score (based on the change in net general government debt to GDP) to a weaker category on 13 sovereigns, and our debt score (based on both net government debt to GDP and on government interest payments to revenues) on 10 sovereigns since the pandemic began (see Chart 15). These changes indicate that, in common with other parts of the world, governments in the region ran large fiscal deficits last year and are likely to run substantial ones again in 2021, due to falling revenues and rising spending to manage the social and economic impact of the pandemic. According the UN Economic Commission for Latin America and the Caribbean (ECLAC) estimates, government spending as a share of GDP rose 3.3 ppts on average in 2020, with about two-thirds of the increase due to higher subsidies and current transfers. Falling revenues and higher spending resulted in a substantial rise in fiscal deficits and sovereign debt, contributing to weaker creditworthiness.

Chart 14

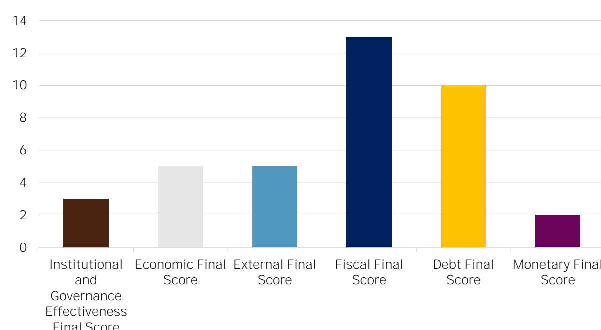
Negative Rating Actions LatAm And The Caribbean



Note: From Jan. 2020 to Sept. 2021. Source: S&P Global Ratings.

Chart 15

Worsening Rating Factors LatAm And The Caribbean



Note: From Jan. 2020 to Sept. 2021. Source: S&P Global Ratings.

In contrast, we revised our external assessment and our monetary assessment scores to a weaker category on only a couple of countries, indicating that the pandemic's main rating impact has been in the form of fiscal and debt deterioration. The relative stability in external and monetary rating

factors stands in contrast with the typical pattern in LatAm during stressful periods in the last decades of the 20th century, when countries often suffered from high inflation and severe balance of payments crises that led to defaults.

The trajectory of sovereign ratings after the pandemic fades will largely depend on the ability of countries to achieve sustained and rapid GDP growth, which is a pre-requisite for stabilizing and eventually reversing the recent weakening of public finances and for reducing poverty, joblessness, and social tensions in many countries. However, GDP is not likely to return to 2019 levels until 2022 or later in much of the region, and growth prospects afterwards are constrained by long-standing structural weaknesses.

Our 'BBB' ratings on Mexico incorporates the likelihood of continued weak economic performance. Although GDP may grow about 6% in 2021 after contracting 8.5% last year, the country's long-term growth trajectory is likely just above 2%, below that of other countries at the same level of economic development. Poor growth prospects partly reflect strained relations between the government and much of the private sector, dampening prospects for private investment and limiting the government's ability to maintain moderate fiscal deficits. Our negative outlook on our rating on Mexico reflects the risk of a weaker fiscal profile (including from off-budget contingent liabilities).

Our 'BB-' ratings and stable outlook on Brazil assume a gradual reduction in its large fiscal deficit (more than 13% of GDP in 2020), which should result in a slower pace of debt accumulation in coming years, as well as continued solid external performance. After around 5% GDP growth in 2021, Brazil is likely to grow approximately 2% in later years, absent the passage of long-pending fiscal and structural reforms needed to boost productivity and investment. However, persistent fiscal weakness could translate into further financing pressures for the government and higher debt costs and inflation. Political uncertainty is likely to rise with the approach of national elections in 2022.

Political uncertainty has increased in Chile ('A'), Peru ('BBB+'), and Colombia ('BB+'), although we have a stable outlook on all three countries. The Chilean economy is likely to rebound faster in 2021 (around 9%) than most in the region, helping stabilize a recent erosion of public finances. However, the country's long-term growth prospects (currently projected around 3%) could be weighed by uncertainty over upcoming national elections later this year and from the drafting of a new constitution, which has already started.

Recent national elections in Peru led to a fragmented Congress and a new president with a narrow political base, prolonging political instability in a country that had four presidents and elected two Congresses in the past four years. Sharpened political and social divisions pose challenges for newly-elected leftist president Pedro Castillo. Peru's GDP grew 4.9% on average during 2001-2019, almost double the pace of the six largest economies in LatAm, slashing poverty to about 15% from 45% and building fiscal buffers. However, the pandemic has partly reversed these impressive gains and created new political tensions. A potentially prolonged political impasse could erode investor confidence, imperil GDP growth prospects, and gradually weaken Peru's financial profile.

The impact of the pandemic and recent social protest on Colombia's political dynamics will become clearer after national elections next year. The new administration will face difficulties achieving solid GDP growth and stabilizing public finances, while likely increasing spending on social services.

EM EMEA

It's hardly surprising that COVID-19 continues to cast a long shadow over public finances across global sovereigns. But the situation remains particularly acute for the majority of the 53 EM governments S&P Global rates in EMEA. Out of these 53, 36 face net public-sector borrowing requirements in excess of 5 % of GDP this year. While this scale of fiscal deterioration, when measured by the size of budgetary deficits is no worse (and in many cases less bad) than the deterioration of public finances in advanced economies, the critical difference (which goes to the heart of debt sustainability) is the cost of financing. When measured as a percentage of revenues, interest payments are projected to top one-sixth of government receipts in 11 out of the 36 EMEA sovereigns where net borrowing is still sizeable. The median rating for these 11 countries is 'B', but it also includes higher rated sovereigns such as South Africa ('BB-'), and Sharjah ('BBB-'). For Angola, Ghana, Kenya, Zambia, Egypt, Bahrain, and Nigeria, the cost of interest now absorbs one quarter or more of total revenues. Such a level of crowding out of public resources could lead to rising defaults, particularly if China's economic slowdown reduces prices of the more cyclical exports that many African economies rely upon for fiscal and FX earnings. Low vaccination rates continue to drag on the recovery in large parts of EMEA, not least in Africa, and frustration with perceived corruption/misspending has ramped up pressures on governments to deliver more fiscal support to households.

On the other side of the divide, despite net borrowing requirements of at least 5% of GDP this year, Romania ('BBB-'), Botswana ('BBB+'), Poland ('A-'), Serbia ('BB+'), and Tajikistan ('B-') are paying less than 5% of revenues on interest during 2021. Ethiopia also falls under this category, though once state-owned enterprise debt is included, the cost of debt service rises considerably (and the figures are further depressed given the amount of financial repression that takes place in its predominantly state-owned financial sector).

The other theme for EM EMEA during the remainder of 2021 is almost certain to be China. Between Eastern European economies integrated into Germany's capital machinery supply chain, and metals exporters in Sub-Saharan Africa, it's difficult to find an economy that wouldn't feel the impact from the first and second round effects of a seizing up of China's construction boom. Of the 53 EM EMEA sovereigns we closely track, the sovereigns most sensitive to a falloff in construction activity in China include both Eastern European machinery and component exporters such as Hungary, Poland, and Serbia, along with Turkey, as well as exporters of more cyclical commodity products, particularly industrial metals such as South Africa, Democratic Republic of the Congo, Congo Brazzaville, Zambia, and Mozambique. However, advanced economies with large manufacturing sectors, particularly Germany and even Italy, are likely to be at least as exposed in such a scenario as well, though not quite to the same degree as South Korea and Japan.

Corporations

EM Asia

More Defaults Are Likely Amid Volatile Capital Markets

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The favorable credit momentum that had emerged in EM Asia since the beginning of the second quarter of 2021 appears to fizzle out heading into the last quarter of the year. The culprits: rising regulatory risks in China and the financial stress of large regional issuers, which are increasing capital market volatility and eroding investor sentiment. The zero-COVID policy adopted by several countries in the region, most notably China, had a limited impact on corporate credit quality so far. But because it involves localized lockdowns and other restrictions on mobility and is unlikely to be lifted soon, it will limit the speed of revenue and profit recovery. With about 10% of ratings in EM Asia at 'B-' or below, we expect more defaults or debt restructurings in the region, especially in the Chinese real estate sector and among the smaller issuers facing debt maturities in 2022 across the manufacturing and commodity sectors in Indonesia.

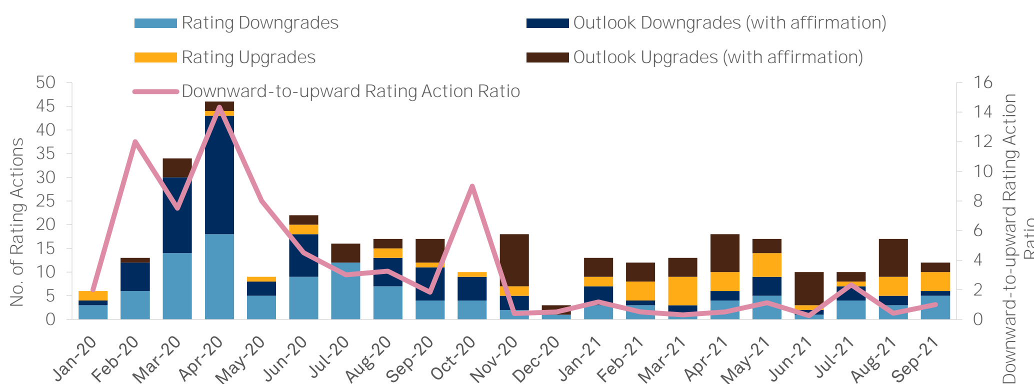
In EM Asia, slightly less than one in five of our investment-grade ratings and slightly less 30% of speculative-grade ratings have negative outlooks or are on CreditWatch negative as of Sept. 22, 2021. These statistics are a few percent lower than they were in June 2021. Downside rating risk has diminished across China, Indonesia, and India, This is either because economic growth has been more supportive (China and India) or because a favorable fund-raising window in the third quarter of 2021 allowed lower-rated issuers to refinance maturing debts (Indonesia). Credit trends in the Indonesian corporate sector continue to stand out as somewhat more negative than elsewhere in the region.--nearly one-third of Indonesian corporate issuers are at risk of further negative rating actions. COVID-19 cases regularly flare up amid a slow rollout of vaccination, with intermittent and localized lockdowns weighing on consumer sentiment. At the same time, funding by banks and capital markets is staying selective.

Out of the 16 sectors in which we rate corporate issuers in EM Asia, only eight sectors will return to pre-pandemic credit metrics by the end of 2021. This leaves the "year of the recovery" only halfway there. Overall, credit metrics of companies in the chemicals, discretionary consumer, capital good or non-essential retail sectors will only recover by the second half of 2022. Credit metrics of those issuers in mobility-affected sectors such as gaming, transportation, and airports are unlikely to recover until 2023 or 2024.

Chart 16

The Upside Credit Momentum Is Plateauing For Companies In EM Asia

Corporate Rating Changes In China, Indonesia, And India



Source: S&P Global Ratings. Aggregated number of rating movements for rated companies in China, India and Indonesia. Outlook upgrades includes outlooks revised to 'positive' from 'stable' and outlooks revised to 'stable' from 'negative'. Outlook downgrades includes outlooks revised to 'stable' from 'positive' and outlooks revised to 'negative' from 'stable'. Data as of Sept. 24, 2021.

Access to funding remains a greater determinant of credit trajectory in EM Asia than operating performance or GDP growth. In that respect, the main development we're watching heading into the fourth quarter is stress among large and highly leveraged borrowers in the region. Jitters from the financial stress at large Chinese real estate developer China Evergrande Group--one of the largest private borrowers in Asia--are likely to stay contained to the domestic real estate sector. This is because the sector faces elevated policy risks, massive refinancing needs in the next 12 months, and persistent idiosyncratic events that continue to dent investor sentiment. But they illustrate that funding channels can dry up quickly even for well-established, large borrowers, especially if they're highly leveraged. We believe this risk-on/risk-off investor sentiment is likely to linger for the rest of the year and create refinancing headwinds for lower-rated issuers.

Regulatory risk is an emerging risk factor that we're watching closely in China. The Chinese government has been tightening regulations across half a dozen sectors over the past few months, most recently in the education sector, while Macau launched consultations ahead of possible amendments to its gaming law. We believe more regulation is likely in the next 12 months as the government increasingly focuses on addressing the imbalances between economic growth and social equity, on leveling the playing field in concentrated sectors, ensuring data security, protecting consumer and worker rights, and reducing the cost of living, particularly housing, education, and health care. While these objectives are not new, their implementation and communication are likely to bring surprises, and similar to the recent case of the Macau casino sector, drive market volatility, raise funding costs, and temporarily restrict access to capital markets.

EM EMEA

Saudi Arabia's Gradual Recovery Continues, Accompanied By Healthy Capital Market Activity

The general Saudi corporate sector continues to recover, and second-quarter results of the listed Saudi companies show a healthy rebound in revenues and earnings across a number of key sectors, while the recovery for the larger oil and gas sector and the chemical sectors are more pronounced amid a strong recovery in oil prices from last year’s lows. In the meantime, we expect sectors such as tourism and aviation to remain under pressure. Albeit at relatively higher numbers than last year, we understand the Saudi authorities will continue to limit the Islamic pilgrimage to very low numbers this year as well, given the pandemic-related health and safety concerns.

We continue to see increased level of activity in the Kingdom’s capital markets. As of Sept. 12, 2021, Saudi non-financial corporations raised more than $ 9 billion predominantly in the form of Sukuk from the debt capital markets. Saudi Aramco (unrated) alone raised $ 6 billion in June through its debut sukuk, while the Kingdom’s IPO market also remains very active. As we discussed in "Vision 2030 Will Push Forward Saudi Arabia’s Debt Capital Market," published May 4, 2021, we expect to see the planned infrastructure investments under Saudi Vision 2030 and the resulting funding requirements to translate into visibly higher capital market activity for the Kingdom.

While the pandemic-related disruptions caused delay in a number of key projects in the past 18 months, we expect the implementation/launch of some of the projects under Vision 2030 to accelerate over the next few quarters, boosting activity particularly in sectors such as the energy, infrastructure, and the contracting.

Turkey Posted Strong Performance Thanks To Exports, Services, And Tourism's Healthy Recovery

Data from the Ministry of Culture and Tourism shows substantial recovery in the number of foreign visitors to Turkey over the past few months. Turkey hosted around 12.7 million tourists for the entire 2020. Amid a recovery over the past few months, foreign visitor numbers reached over 10 million in the first seven months of 2021. Around 6.4 million visitors were registered in June and July only. We expect this momentum to continue over the next few months, giving the hotels and tourism operators some breathing space, while recovery to pre-pandemic numbers will take several quarters.

Similarly, thanks to the gradual recovery in global and regional economy, as well as trade, Turkey's exporting sectors including manufactured products, such as automotive and consumer durables, had visibly stronger performance in the first seven months of the year. And we expect this trend to continue in the remaining months of 2021.

In the meantime, in 2021, Turkish corporations will continue to digest the combined effect of higher domestic interest rates in 2021 and a weaker Turkish lira, which can create challenges particularly for corporations with foreign currency debt without matching foreign currency revenues.

Russia's Largest Corporations Are Waiting For Post-Election Tax Changes

The performance of Russian corporations remains robust across the largest industries. Russia's exporters enjoy very supportive prices on hydrocarbons and metals, and they're set to post record high EBITDA numbers for 2021. Given that leverage was already moderate, this exceptional cash flow largely goes to the shareholders, but without hurting the creditworthiness. Still, a few companies used this opportunity to further strengthen their balance sheets, which resulted in positive rating actions. In other sectors, performance has largely returned to pre-pandemic levels, but further upside is constrained by Russia's likely weak economic growth starting in 2022.

The government's plans to boost economic growth through investments in infrastructure would require additional financing, and the corporate sector expects the government to announce tax increases in the fourth quarter of 2021. We have previously mentioned that we view this as meaningful risk for some key sectors, including metals and mining. While tax hikes are unlikely to be a gamechanger for the cost position of Russian producers, they would likely prompt companies to adjust their capital spending so that they can stay within their financial policy targets.

As Leverage Trends Downward In South Africa, Event Risk Raises Its Head

South Africa-based corporations continue to deleverage as the most acute pandemic-related effects abate, and we forecast leverage across many issuers to approach pre-pandemic levels by 2022. Median corporate leverage (debt to EBITDA) metrics improved from 2.1x at the end of 2020 to 1.7x in May 2021 and have stabilized at this level for now. Lower average leverage in 2021 to date is largely underpinned by the supportive commodity prices, together with meaningful asset and capex optimization among some companies. However, leverage trajectories differ markedly across industry sectors, with commodity-exposed issuers leading the field. More generally, the negative impacts of affordability and mobility restrictions on discretionary spending, and pandemic-related supply chain disruption continue to ease, improving operating momentum, and cost and cash management discipline initiated during the pandemic appear to be leading to permanent efficiency gains in corporations.

While credit metrics have generally been supportive of credit quality, event risk has increased following two incidents which took place in July 2021. Civil unrest and riots in South Africa's two most economically active provinces disrupted the operations of some retailers and supply chains in the first half of July, as highlighted in our June 26 article, "Social Unrest In South Africa Is A Reminder Of Institutional And Structural Constraints To A Fragile Recovery." While we don't view the recent social unrest as a driver of South African corporate credit ratings in the short term, there could be longer-term implications. This is because the damage to elements of the country's retail and financial infrastructure, economy, and consumer and investor confidence takes longer to repair. It's alleged that agitation by political elements and widespread criminality sparked the riots, but their persistence speaks to widespread frustration among the population beset by income inequality, increasing poverty levels, and poor access to health services, in our view. Supply chains were further hampered in the latter part of July following a cyber-attack on Transnet, the country's rail, port, and pipeline owner, which hampered container and port activities.

Aside from the July events, perennial issues such as electricity supply and transportation infrastructure constraints remain, discouraging capital investment in South Africa and curtailing the economic recovery. The South African rand's volatility and potential upward pressure on corporate input costs and inflation, stemming from stronger oil prices, are also on the agenda. On

the positive side, vaccination rollout is gaining momentum, with around 10% of the population fully vaccinated, according to official statistics.

Funding conditions and pricing remain supportive, even for issuers in the 'B' category, although corporate debt issuances in the region remains muted. Longer terms and lower rates than prior to the pandemic have been achieved by large players in ‘essential service’ industries such as mining, pulp/paper, and telecoms. Some companies are using cash windfalls (from high commodity prices or asset sales) and supportive market conditions to downsize and term out funding or change currency mixes to reduce foreign exchange risk. Fundraising by state-owned entities is more constrained, with heavy reliance on government-guaranteed or DFI funding. Lender support which was broadly available through the pandemic in the form of covenant waivers and lifts is now largely unnecessary, and most companies will exit their forbearance periods soon.

LatAm

As The Pandemic's Intensity Recedes And Business Conditions Improve, New Risks Emerge

Corporate performance continues to exceed our previous recovery expectations, and credit metrics in approximately two-thirds of the industries in our rated portfolio will return to pre-pandemic levels by the end of the year. This recovery has been supported by stronger-than-expected demand for essential consumer products and services, as well as the sharp increase in commodity prices, including metals, crude oil, and agricultural products.

Exposure to COVID-19 remains a substantial threat for all corporations, given that mobility across the region hasn’t yet returned to normal levels. However, we believe that the pandemic-related headwinds that the sector faced last year are a lesser credit risk, because governments continue to make progress in vaccination rates, and companies continue to protect liquidity and profitability.

Although business conditions are generally improving in the region, other risks are becoming more relevant. On one hand, manufacturing capacity constraints and limited manpower in Asia are triggering supply-chain disruptions: freight costs have consistently increased in recent months and inventory shortages are on the rise. Global inflationary pressures are also squeezing margins of some corporations, and the gradual normalization of interest rates is increasing financing costs.

More specifically, Brazil's presidential election in October 2022 creates uncertainty about economic and fiscal policies in a highly polarized political landscape. In our view, it will be challenging to advance private investment as the election approaches and as risks stemming from the pandemic's course persist.

In Mexico, one of the main risks relates to the potential sovereign downgrade, which, if materialized, would likely trigger several negative rating actions among rated domestic entities that currently have a sovereign rating cap. Yet, vaccination is progressing and helping restore consumer confidence, with 32.8% of the population fully vaccinated as of mid-September, ahead of regional peers. The recovery of the U.S. economy is also pulling along export manufacturing activities and boosting remittances.

Argentina's November mid-term elections could make policymaking more difficult, and the absence of a new deal with the IMF reduces medium-term visibility. On top of severe economic difficulties and job losses, companies are dealing with rampant inflation and a persistently weak peso, because the government has provided massive monetary stimulus to cope with revenue drops and higher fiscal spending. The scenario has mildly improved this year, but reaching pre-pandemic levels will take at least another year.

Financial Services

EM Asia

COVID-19 Resurgence Is Exacerbating Downside Pressure On Banks

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Protracted lockdowns, rampant pandemic waves, and prolonged regulatory forbearances have raised downside risks for near-term recovery across Thailand, Indonesia, and Malaysia. This has also reduced the buffers of local banking sectors. As the pandemic drags on, finances will deteriorate among households, small and midsize enterprises, and the wider economy, leading to greater medium-term economic damage. We now expect economic growth in the three countries to be significantly lower.

Table 4

Severe Pandemic Waves In Malaysia, Thailand, And Indonesia Have Hurt GDP

Real GDP Growth (%)	2019	2020	2021f	2022f	2023f	2024f
Indonesia	5.0	-2.1	3.4	5.6	4.8	4.8
Malaysia	4.4	-5.6	3.2	6.0	5.2	4.6
Thailand	2.3	-6.1	1.1	3.6	4.2	2.9
EM Asia	5.3	-1.1	7.6	5.8	5.2	5.2

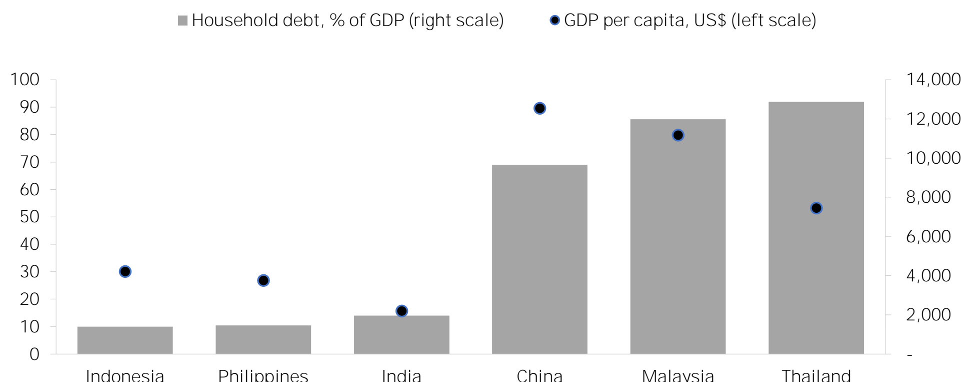
Source: S&P Global Ratings.

The debt-servicing ability of the borrowers in these countries has taken a blow from recent pandemic waves. Loans under relief measures (either a moratorium or restructuring) in all the three markets are high, at 15%-30%, and we expect them to remain elevated. The regulatory forbearance will delay the recognition of weak loans. In our view, a high proportion of the banks' loan books under relief measures for a long period of time indicate incipient problems in the banking system, and we believe that the downside risks for the three banking systems remains elevated.

Malaysian and Thai households are also among the most leveraged in the region. We are slightly more concerned over Thailand because the household income and savings are lower (See chart 17), and domestic banks have a higher proportion of consumer loans (car and other unsecured loans) than low-risk mortgages . Moreover, underwriting standards are weaker among Thai banks than those in Malaysia. The loan-to-value ratio for mortgages in Malaysia is below 70%, versus 80%-90% for Thailand.

Chart 17

Thai And Malaysian Households Are Among The Most Leveraged



Data for 2021. Source: S&P Global Ratings Estimates.

Were increasingly concerned about the rising the Malaysian government's intervention in the sector. The recent announcement of a fourth-quarter interest-free moratorium program for B50 (the bottom 50% of individual borrowers in terms of income) clients is not only earnings dilutive for Malaysian banks, but could also hurt credit culture in the medium to long term.

Elevated Credit Costs To Persist In Thai, Malaysian, And Indonesian Banks

Thailand: Credit risk is very high, given the substantial household and corporate debt. The pandemic's rising intensity has pushed back the likely timelines for greater normalization of domestic activity and a gradual resumption of tourism. We estimate the average nonperforming loans (NPL) ratio will rise gradually and peak at 6% in 2022, the highest since the 2009 global financial crisis. In our view, credit losses will remain steep at 1.7% in 2021, up from 1.2% in 2019.

Malaysia: Our base-case scenario assumes that the banking industry's NPL ratio to reach 3%-4% and credit costs to stay at 55-60 basis points (bps) in 2021 and 2022 before falling gradually. As of mid-August, the moratorium take-up rate for the banking industry has risen to 25%-30% of domestic loan book from 15% as the second, six-month moratorium took place in early July. We expect the moratorium take-up rate to rise much higher if the interest waiver initiative is applicable to all eligible B50 individual borrowers under the current automatic approval application criteria. The B40 group generally accounts for 20%-25% of retail loans among rated Malaysian banks.

Indonesia: We expect reported NPLs to remain at 3.0%-3.5% in 2021. Restructured loans grew to about 18% of total loans in 2020 and could inch up this year due to the pandemic's escalation. Regulatory forbearance allowing restructured loans to be classified as performing until the of end of March 2022 will mitigate immediate damage to banks' financial results. Underlying deterioration in asset quality could become more apparent in 2022 after the regulatory relaxation measures are lifted. We estimate that 10%-15% of restructured loans are vulnerable, which could translate into a 1.5-3.0 percentage points increase in NPLs.

We could lower our ratings on the banks in these countries if the impact on economy is significantly more severe or prolonged with greater permanent scarring of the household and SMEs finances than our current forecast. In such a scenario, banks could have substantially higher nonperforming assets and credit losses. Additionally, Indonesian banks are vulnerable to second order impact if Rupiah depreciates, because more than half of Indonesian corporate loans are in foreign currencies. Finally, the negative outlook on the ratings on Malaysia and Indonesia will also weigh on banking sectors. The governments' borrower relief measures won't eliminate all the risks. The true cost of the pandemic is yet unknown.

Capital and provisioning buffers, built up over the years, should provide some buffers to the banks through the economic downturn. Indonesian banks have the strongest earnings and highest capital adequacy in the region. Their average Tier-1 capital ratio of 22.2% and capital adequacy ratio of 24.0%, as of March 2021 support their credit profile. We also expect domestic banks to maintain a healthy level of local currency deposits, reflecting the banks' dominant retail presence and strong consumer confidence. Thai banks also have achieved strong provision coverage; the top six rated banks' provisioning coverage was more than 150%, with a capital adequacy ratio of 18.5% as of June 2021.

EM EMEA

Turkish Banks' NPLs Will Remain High Despite The Economic Recovery

While the economy seems to be holding up, we still expect banks' asset quality indicators to deteriorate with NPLs exceeding 10% of total loans by 2022 and cost of risk rising to 320 bps on average in 2021 and 2022, as regulatory forbearance measures are lifted and lira to remain weak. In the first half of 2021, a combination of write-offs and lending growth reduced the NPLs ratio to 3.8% from 4.3% at the end of 2020. We expect lending growth to slow in 2021 to 16%-18% from 35% in 2020. We expect most new loans to be in the consumer segment, while corporate lending expansion will continue to be partly driven by the lira's depreciation. External debt declined slightly to $144 billion, or $107.3 billion when factoring only wholesale debt (interbank and issuances on

capital market), as of June 30, 2021, from $149 billion at the end of 2020. Rollover rates continued to be strong, but Turkey remains vulnerable to either a change in the country's policy direction or a tapering of the Fed's asset purchase program. As of June 30, 2021, the banking system had $105.9 billion of foreign currency denominated liquid assets including 40.5% in the form of reserves with the central bank of Turkey. A portion of these funds could be deployed if the system were to face lower rollover rates. Finally, dollarization remained stable with 55.5% of deposits denominated in that currency.

Subdued Credit Growth, And Easing Credit Losses For South African Banks

We forecast credit growth in the private sector to be subdued in 2021. We estimate that credit losses are likely to start decreasing to 1.7% in 2021 from 2.1% in 2020 and NPLs will likely increase to 5% of total loans over this period. Despite a sharp drop in earnings, the major banks remained profitable and their capital ratios resilient in 2020. We expect this trend to continue in 2021. Although top-tier banks are exposed to wholesale short-term deposits, these largely stem from domestic nonbank financial institutions. Banks are, therefore, not exposed to large-scale refinancing risk or a reversal of investor sentiment, because they don't rely on international funding.

Strong Credit Growth Will Carry Into 2022 In Saudi Arabia

The Saudi economy is recovering from the shocks of 2020 as global demand for oil rebounds and private consumption increases. Growth of mortgage portfolios and the gradual launch of Vision-2030 landmark construction projects will support overall credit growth, which we now expect to reach 15% in 2021 and stay above 10% in 2022. We believe that the pandemic had a deeper impact on the non-oil economy than the decline in oil prices in 2014. As deferral programs are gradually phased out and the economy adjusts to the new normal, the cost of risk will stay unchanged in 2021, at 90-100 bps (down from 100 bps in 2020), before starting to gradually normalize in 2022. High growth rates can, however, obscure the numbers. Along with lower interest rates, this will put pressure on Saudi banks' profitability, which will only partly be offset by a higher share of loans in total assets. We expect Saudi banks to navigate these headwinds and maintain a return on average assets of 1.4%-1.5% in coming years, down from 2% prior to 2020. We expect banks' funding profile to continue supporting their creditworthiness. Despite gradual buildup of external funding, the Saudi banking sector remains predominantly funded by customer deposits, which have been stable. Although we expect some further increase in external debt, the banking sector will remain a net external creditor.

Improving Economy Will Lift Asset Quality In Russia

As commodity prices remain supportive and the global economy picks up, we estimate Russia's GDP growth could be about 4.0% in 2021 and average 2.2% in 2022-2023. Russian banks entered the recession in a better shape than during the previous downturn, and we expect the banking system to demonstrate resilience. Stronger-than-expected economic recovery and selective pandemic-related restrictions, an economy with a large public sector, and a comparatively small role played by vulnerable service sectors support business dynamism and stable asset quality of Russian banks. We assume that problematic loans may fall to 8%-10% by the end of 2021. By contrast, the largest banks reported Stage 3 loans of about 6.7% as of mid-2021. We estimate credit losses in Russia's banking sector could be contained and average 1.5% in 2021, compared with the modest annualized 60 bps for the first half of 2021 and 2.1% in 2020. The funding base of Russian banking sector has been stable thanks to heavy reliance on domestic deposits, availability of liquidity support from the central bank, and limited exposure to external funding.

LatAm

We expect credit growth in 2021 to moderate from strong levels last year to single digits, mainly due to the absence of extraordinary measures from the governments. Last year, we observed a spike in credit demand among Latin American companies seeking to strengthen their liquidity positions to withstand the looming economic crisis. Currently, we expect low credit demand from the corporate

sector, and we expect lending opportunities in the retail segments, particularly for lower risk products, such as payroll deductible loans, auto loans, and mortgage loans.

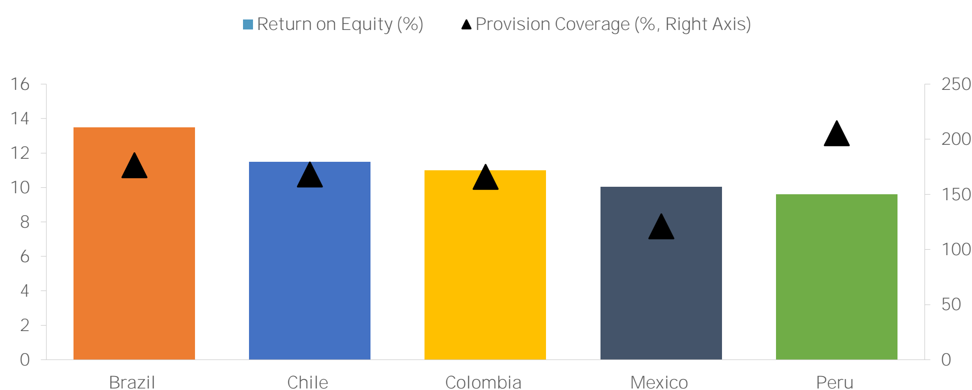
We predict lower provisioning needs, despite asset quality's likely slippage. This is because Latin American banks have built up significant levels of extraordinary provisions last year, which depressed their bottom-line results. We believe provisioning that banks raised so far will be sufficient to absorb the deterioration in asset quality stemming from the pandemic-induced economic shock.

Debt moratorium programs in the Latin American banking systems ended prior to the end of 2020, and we observed that most of loans under those programs resumed payments, and the remaining ones were restructured, while a minority became past due.

Profitability metrics are recovering but still lagging the 2019 levels. In general, we expect these metrics to recover to pre-pandemic levels in 2022-2023 (this varies country to country), reflecting less pressure from provisions going forward and a gradual margin and fee income recovery.

Chart 18

Profitability Levels Still Lag 2019 Levels



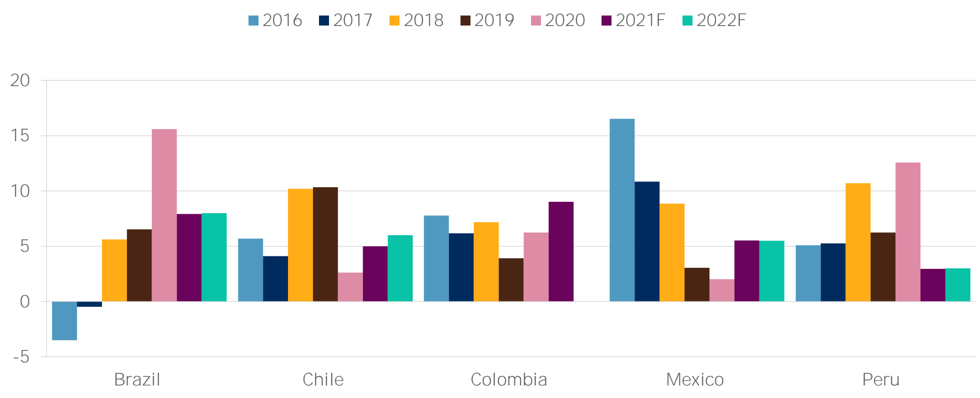
Source: S&P Global Ratings forecast 2021.

Higher inflationary pressures in the region will affect banking systems mainly in two ways. First, higher interest rates could raise funding costs and dampen margins if banks are unable to transfer the higher cost to their borrowers. Second, inflation could weigh on households and corporations' payment capacity and on banks' asset quality. We believe that Latin American banks can cope with the increasing interest rates, as they did in the past, by transferring the rising funding costs to borrowers.

We expect lending growth to moderate in 2021 from high levels in countries where we saw stronger incentives from the government to lend, such as Brazil and Peru. In contrast, we expect lending to resume growing after a contraction in Mexico and Colombia, in which incentives from the government were absent. We expect banks’ lending to be modest in the region for the next two years, because we expect they'll take a conservative approach, given the uncertain scenario in most countries.

Chart 19

We Expect Loan Growth To Be Modest In The Next Two Years (Loan Growth [%])



Source: S&P Global Ratings.

Asset quality is better than we expected, as banks lift loan moratoriums, but challenges remain. High levels of informal economy and fragile conditions for SMEs will pressure loan portfolios as government measures for borrower relief are withdrawn. The economic rebound that we expect in Latin America is a crucial factor that could help cushion asset quality performance.

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Appendix 1: Economic Data And Forecast Summaries

Table 5

Real GDP %

	2020	2021F	2022F	2023F
Argentina	(9.9)	7.2	2.1	2.2
Brazil	(4.4)	5.1	1.8	2.2
Chile	(6.0)	9.0	2.5	3.0
Colombia	(6.8)	8.0	3.0	3.3
Mexico	(8.5)	6.2	2.9	2.2
China	2.3	8.0	5.1	5.0
India	(7.3)	9.5	7.8	5.7
Indonesia	(2.1)	3.4	5.6	4.8
Malaysia	(5.6)	3.2	6.0	5.2
Philippines	(9.6)	4.3	7.7	7.4
Thailand	(6.1)	1.1	3.6	4.2
Poland	(2.7)	5.1	5.3	3.4
Russia	(3.0)	4.0	2.6	2.0
Saudi Arabia	(4.1)	1.9	2.9	2.4
South Africa	(6.4)	4.6	2.6	1.5
Turkey	1.8	8.6	3.3	3.1

F--S&P Global Ratings' forecast. For India, 2020 = FY 2020 / 21, 2021 = FY 2021 / 22, 2022 = FY 2022 / 23, 2023 = FY 2023 / 24.

Table 6

CPI Inflation % (Year Average)

	2020	2021F	2022F	2023F
Argentina	42.0	47.5	42.0	36.0
Brazil	3.2	7.8	5.9	3.5
Chile	3.0	4.2	4.6	3.2
Colombia	2.5	3.6	4.3	3.2
Mexico	3.4	5.5	4.3	3.2
China	2.5	0.9	1.8	2.2
India	6.2	5.8	5.0	4.5
Indonesia	2.0	1.7	2.9	2.8
Malaysia	(1.1)	2.7	2.2	2.3
Philippines	2.6	4.5	2.2	2.5
Thailand	(0.8)	0.9	1.0	1.1
Poland	3.7	4.4	3.3	3.1
Russia	3.4	6.1	4.2	4.0
Saudi Arabia	3.4	3.1	2.3	2.1
South Africa	3.3	4.4	4.6	4.5
Turkey	12.3	17.3	12.0	9.6

F--S&P Global Ratings' forecast. For India, 2019 = FY 2019 / 20, 2020 = FY 2020 / 21, 2021 = FY 2021 / 22, 2022 = FY 2022 / 23, 2023 = FY 2023 / 24. Source: Oxford Economics.

Table 7

Policy Rates % (End of Period)

	2020	2021F	2022F	2023F
Argentina	38.00	38.00	33.00	30.00
Brazil	2.00	8.00	8.50	7.00
Chile	0.50	3.00	3.50	3.50
Colombia	1.75	2.75	3.75	4.25
Mexico	4.25	5.00	5.50	5.50
India	4.00	4.25	4.75	5.25
Indonesia	3.75	3.50	4.00	4.50
Malaysia	1.75	1.75	2.00	2.50
Philippines	2.00	2.00	2.00	2.75
Thailand	0.50	0.50	0.50	0.50
Poland	0.10	0.10	1.00	1.50
Russia	4.25	7.00	6.50	5.50
South Africa	3.50	3.50	4.00	5.00
Turkey	17.03	17.00	13.00	9.75

F--S&P Global Ratings' forecast. Source: Oxford Economics.

Table 8

Exchange Rates % (End of Period)

	2020	2021F	2022F	2023F
Argentina	84.15	110.00	155.00	200.00
Brazil	5.20	5.25	5.35	5.40
Chile	729	750	755	760
Colombia	3,432	3,725	3,750	3,800
Mexico	19.88	20.50	21.00	21.50
China	6.52	6.45	6.40	6.35
India	72.90	75.00	76.00	77.00
Indonesia	14,050	14,500	14,650	14,800
Malaysia	4.01	4.18	4.22	4.25
Philippines	48.04	50.00	50.35	51.16
Thailand	30.04	32.80	33.00	32.80
Poland	3.76	3.83	3.77	3.77
Russia	73.88	72.00	74.00	76.00
Saudi Arabia	3.75	3.75	3.75	3.75
South Africa	14.62	14.80	15.83	16.20
Turkey	7.44	8.70	8.84	9.11

F--S&P Global Ratings' forecast. End of Period - Q4 values. For India, 2019 = FY 2019 / 20, 2020 = FY 2020 / 21, 2021 = FY 2021 / 22, 2022 = FY 2022 / 23, 2023 = FY 2023 / 24. Source: Oxford Economics.

Table 9

Unemployment % (Year Average)

	2020	2021F	2022F	2023F
Argentina	11.6	10.0	9.3	9.0
Brazil	13.5	14.0	12.9	12.3
Chile	10.8	9.3	8.9	8.2
Colombia	16.1	14.5	13.1	12.2
Mexico	4.6	4.4	4.3	4.1
China	5.7	5.1	5.0	4.9
Indonesia	6.1	6.4	5.8	5.5
Malaysia	4.5	4.8	4.4	4.0
Philippines	10.4	7.9	6.8	5.6
Thailand	1.7	2.2	2.0	1.7
Poland	3.2	3.6	3.4	3.3
Russia	5.8	4.9	4.7	4.6
Saudi Arabia	7.4	10.0	8.0	6.0
South Africa	29.2	33.6	31.4	30.1
Turkey	13.2	12.6	12.2	11.2

F--S&P Global Ratings' forecast. Source: Oxford Economics.

Related Research

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