Credit Conditions North America:

As Recovery Rolls On, Inflation Risks Remain

Regional Credit Conditions Chair

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Key Takeaways

- **Overall:** Credit conditions remain largely favorable, although risks are looming—primarily those around inflation pressures and supply disruptions (including labor shortages) that many borrowers face. The potential for coronavirus variants such as omicron adds another layer of uncertainty about the pandemic and its effects on the economy and credit.
- **Credit:** The North American net negative outlook bias among corporate borrowers has narrowed to just 5%, the lowest since December 2014. In this light, we see the U.S. trailing-12-month speculative-grade default rate reaching 2.5% by September of next year.
- **Risks:** With inflation running "stronger and longer," the potential for central bank policy missteps has increased. As price pressures combine with supply constraints, investors could soon demand higher returns for the risks they're assuming. This could result in the repricing of financial and real assets, higher debt-servicing costs, and tighter financing conditions.

(Editor's note: S&P Global Ratings' North America Credit Conditions Committee took place on Nov. 22, 2021.)

Credit conditions remain largely favorable for North American borrowers, but risks are looming—not the least of which are the heightened input-cost pressures and ongoing supply disruptions many corporate borrowers face. At the same time, with inflation running hotter and for longer than most economists expected, the potential for central bank monetary-policy missteps has increased. This could result in investors' rapid repricing of risk, raising financing costs for borrowers we rate—particularly those at the lower end of the ratings scale.

Persistent inflation may push investors to demand higher returns, thus raising financing costs—particularly for borrowers at the lower end of the ratings scale

We still expect U.S. GDP growth to reach a 37-year high, but we've lowered our forecast for the full year to 5.5%, down from 5.7% in our previous forecast and 6.7% a quarter before that. Complicating the prospects for growth is a jump in coronavirus cases in most U.S. states as the winter weather sets in. A sharp resurgence of the pandemic could exacerbate supply-chain constraints, cause renewed consumer caution, and further curb economic activity.

For corporate borrowers in many sectors, ongoing supply constraints and/or labor shortages will likely persist into second half of 2022, hurting profit margins for some. While pent-up demand has so far outweighed the effects of increasing costs, with many able to pass through prices and maintain profit margins, some sectors have found pass-through to be more difficult. Either way, this capability may not last forever. Barring a stabilization (or drop) in input costs, borrowers in a number of corporate sectors may soon suffer profit-margin erosion.

Companies are trying to balance this push-and-pull with debt leverage near record levels. Spreads on corporate debt are historically low, helping borrowers push out maturities, and the North American net negative outlook bias has narrowed significantly. Still, the ratings distribution among U.S. nonfinancial corporate borrowers is still heavily speculative-grade (63%)—with 44% of borrowers in the 'B' category (which included 'B+' and 'B-'), and 26% at 'B-' or below.

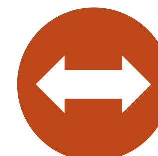
Still, **we see the U.S. trailing-12-month speculative-grade corporate default rate reaching 2.5%** by September of next year, up from 2.4% as of September 2021. But while all indicators imply a slow pace of defaults ahead, we recognize growing risks that, in our pessimistic scenario, could push the default rate to as high as 5.5%.

Meanwhile, **the $1.2 trillion infrastructure bill President Biden signed into law** will benefit borrowers in many areas—including those in U.S. public finance, from local governments to higher-education entities. Elsewhere in Washington, **Congress faces another deadline, in December, to raise the U.S. debt ceiling**, with the Treasury Department relying on "extraordinary measures" to pay its bills through then. S&P Global Ratings doesn't expect the U.S. to default, which would be catastrophic for the economy and financial markets. But as we get closer to the drying up of extraordinary measures, investors could spur significant volatility in financial markets or look to flee from riskier assets. This could drive up financing costs, especially for spec-grade borrowers. In some cases, low-rated borrowers could even be shut out of the capital markets completely.

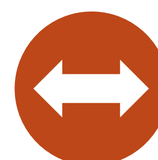
Top North American Risks

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

Persistent high inflation pushes investors to reprice risk
As persistent price pressures combine with continued supply constraints, investors could soon demand significantly higher returns for the risks they're assuming because of fears of runaway inflation, escalating credit concerns, or an unexpected adverse event—such as market turbulence caused by the Fed's tapering of asset purchases or a perceived central bank policy misstep. This could result in the repricing of financial and real assets, higher debt-servicing costs, and tighter financing conditions.



High debt, sustained cost pressures threaten credit quality
With corporate debt leverage near record levels, companies are trying to balance the push-and-pull between increased demand for products and services and the sharp rise in input prices and supply-chain disruptions—many have relied on their ability to pass through prices to maintain profit margins. If cost pressures persist/intensify, or, if inflation begins to weigh heavily on demand, profit erosion could become more widespread and steeper than we expect—and, thus, credit quality could suffer. And while welcoming markets have eased maturity pressures, the draw-down of government support could expose operational and structural headwinds for many.

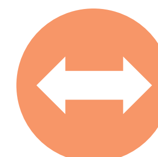


COVID crisis persists, curbing economic activity
While economic activity has proved more resilient to each COVID wave, the omicron variant amplifies the risk of further outbreaks as the cold-weather months force people indoors. An uncontrolled resurgence of the pandemic could cause renewed consumer caution, exacerbate supply-chain and labor constraints, and curb economic activity.

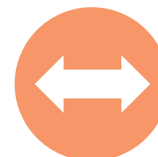
Structural Risks

Energy transition and ESG factors affect business operations, borrowing costs
As the focus intensifies on ESG factors, borrowers that are (or are perceived as being) risky from an ESG perspective could be forced to pay a premium to borrow or be shut out completely from the capital markets. In light of climate change, beyond the physical risks many companies are subject to, the global drive toward a "net-zero" economy also heightens the transition risks (e.g., policy, legal, technology, market, reputation risks) across many sectors, and will likely require significant investments. The recent COP26 event further validated these ongoing concerns.

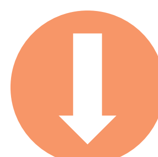
Cyberattacks disrupt business operations and hurt credit quality
Cyber risk continues to pose a systemic threat and significant single-entity event risk, as new targets and methods emerge. The ransomware attack that shut down the U.S. Colonial Pipeline in May exemplifies the growing sophistication and potential ramifications of cyberattacks. As public and private organizations are forced to accelerate their digital transformation, a key to resilience is a robust cybersecurity system, from internal governance to IT software. Entities lacking well-tested playbooks (such as active detection or swift remediation) are most vulnerable.



U.S.-China strategic confrontation worsens
The White House is maintaining pressure on China, while taking a more multilateral approach than the previous administration. Meanwhile, China is striving to be less reliant on foreign markets and technology. While tensions look set to persist in the longer term, we expect less short-term volatility, with actions by both sides to be somewhat more measured. Still, further worsening of the relationship could weigh on trade, intellectual property, investments, and financial transactions, for both and other economies—with some sectors suffering disproportionately.



Declining demand for commercial real estate (office space, in particular) pressures asset valuations, hurts lenders
Because of behavioral shifts in working, living, and spending demand for commercial real estate (CRE) could drop. The recovery of the office sector could lag and lead to a longer-term decline in demand—particularly office space in central business districts, thus pressuring cash flows and asset valuations. While there has been improvement in rent collections, asset performance, and property prices, we may see elevated CRE-related loan losses for debtholders, such as U.S. banks, insurers, REITs, and CMBS, particularly for lower quality assets. For local government issuers, delayed return to office could have implications for tax revenues and property valuation in the downtown core of urban centers.



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