Credit Conditions North America Q1 2022:
As Recovery Rolls On, Inflation Risks Remain

Dec. 7, 2021

S&P Global Ratings' North America Credit Conditions Committee took place on Nov. 22, 2021.
This report does not constitute a rating action.

Contents

			Slide
A.	Key Takeaways		3
B.	North America Top Risks		4
C.	Macroeconomic Outlook	U.S.	5
		Canada	6
D.	Financing Conditions		7-8
E.	Ratings Trends		9-10
F.	U.S. Debt Ceiling		11
G.	Practice Trends	U.S. Public Finance	12
		Nonfinancial Corporates	13-14
		Structured Finance	15-16
		Financial Institutions	17
		Insurance	18
Appendix 1: Economic Data And Forecast Summaries			19
Appendix 2: Contacts			20
Related Research			21

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.

Source: S&P Global Ratings. Credit Conditions North America: As Recovery Rolls On, Inflation Risks Remain, Dec. 1, 2021.

North America Top Risks

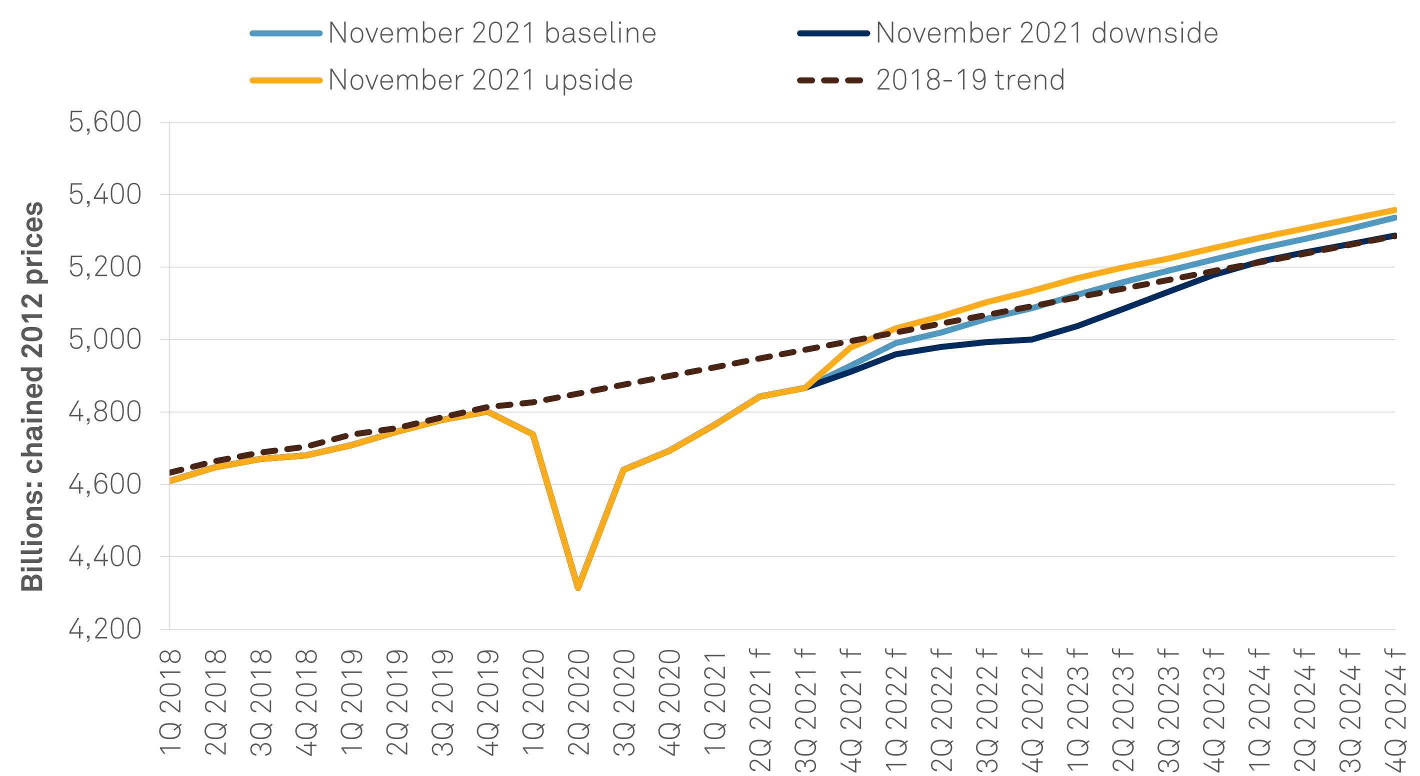
		Risk Level	Risk Trend
	Persistent high inflation pushes investors to reprice risk	High	Unchanged
	High debt, sustained cost pressures threaten credit quality	High	Unchanged
	COVID crisis persists, curbing economic activity	Elevated	Worsening
	Structural Risks		
	Energy transition and ESG factors affect business operations, borrowing costs	Elevated	Worsening
	Cyberattacks disrupt business operations and hurt credit quality	Elevated	Unchanged
	U.S.-China strategic confrontation worsens	Elevated	Unchanged
	Declining demand for commercial real estate (office space, in particular) pressures asset valuations, hurts lenders	Elevated	Improving

** Risk levels may be classified as very low, moderate, elevated, high, or very high, 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 twelve-months.*

Source: S&P Global Ratings. Credit Conditions North America: As Recovery Rolls On, Inflation Risks Remain, Dec. 1, 2021.

U.S. Economic Outlook | Cruising At A Lower Altitude

U.S. Real GDP Scenarios

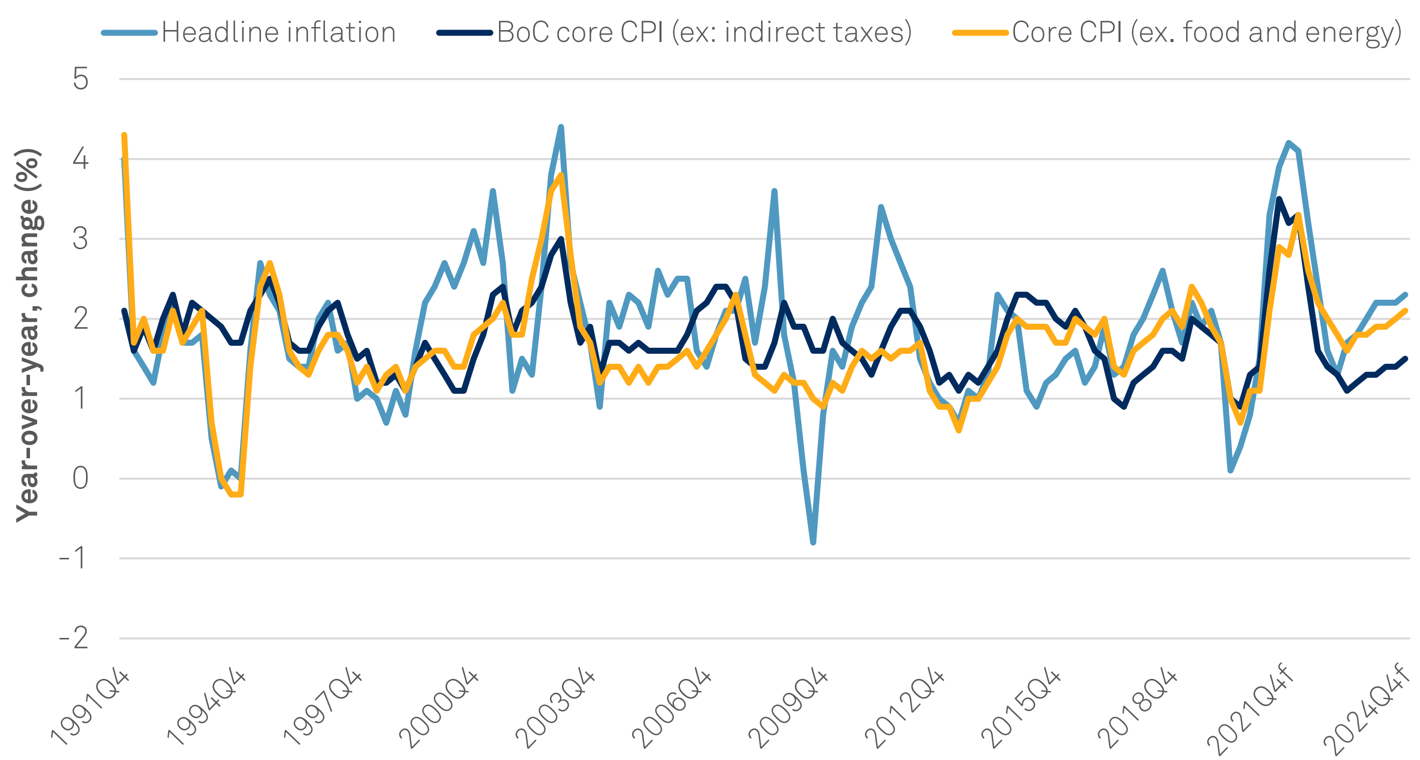


f—Forecast. Sources: Bureau of Economic Analysis, Oxford Economics, and S&P Global Economics' forecasts.
See Economic Outlook U.S. Q1 2022: Cruising At A Lower Altitude, Nov. 29, 2021.

- **GDP growth.** As supply-chain disruptions continue, we forecast U.S. GDP to grow 5.5% in 2021 and 3.9% in 2022.
- **Labor force/unemployment.** The decline in labor force participation, particularly among prime-age workers, is an issue for productivity and growth. We expect the adjusted unemployment rate to reach its precrisis lows in the first quarter of 2023.
- **The Fed.** We expect the Fed to reduce monthly asset purchases by a larger amount next year to reach zero three months earlier in 2022 than at the current $15 billion pace, with the first rate hike a little later in the year. Inflation should reach the Fed's 2% target by late 2023.
- **Downside scenario.** Risks that could lead to a slower-growth downside scenario include the Fed tightening monetary policy faster than it would like, disorderly reflation, repricing risk, distribution of COVID-19 vaccines, new COVID-19 variants, and increasing trade tensions with China.

Canada Economic Outlook | Economy Set To Expand Strongly, COVID-19 And Inflation Risks Remain

Inflation Likely To Slowdown To 2% By H2 2022



f—Forecast. Q—Quarter. CPI — Consumer Price Index. Sources: Oxford Economics and S&P Global Economics.
See Economic Outlook Canada Q1 2022: Economy Set To Expand Strongly, COVID-19 And Inflation Risks Remain, Nov. 29, 2021.

- **GDP growth.** Despite the setback from third and fourth waves of COVID in 2021, the Canadian economy is still on course to expand by a robust 5.0%, and 2022-2023 will likely bring above-potential growth.
- **Inflation.** Our forecast is that consumer price inflation will peak in the fourth quarter of 2021 and early 2022 (on a year over year basis) before reverting in the second half of 2022 to its 2% average, in line with Bank of Canada's (BoC) target. We continue to see inflation as a specific feature of the pandemic crisis that will fade. We now anticipate the BoC will begin its rate hike cycle in April 2022.
- **Risks.** The delta and omicron variants may not represent the virus' last assault, and higher- and longer-than-expected inflation could derail the domestic demand from a robust growth path.

Financing Conditions | On Cruise Control While Looking At Potholes Ahead

U.S. Speculative-Grade Debt Issuance Sets New Record In 2021

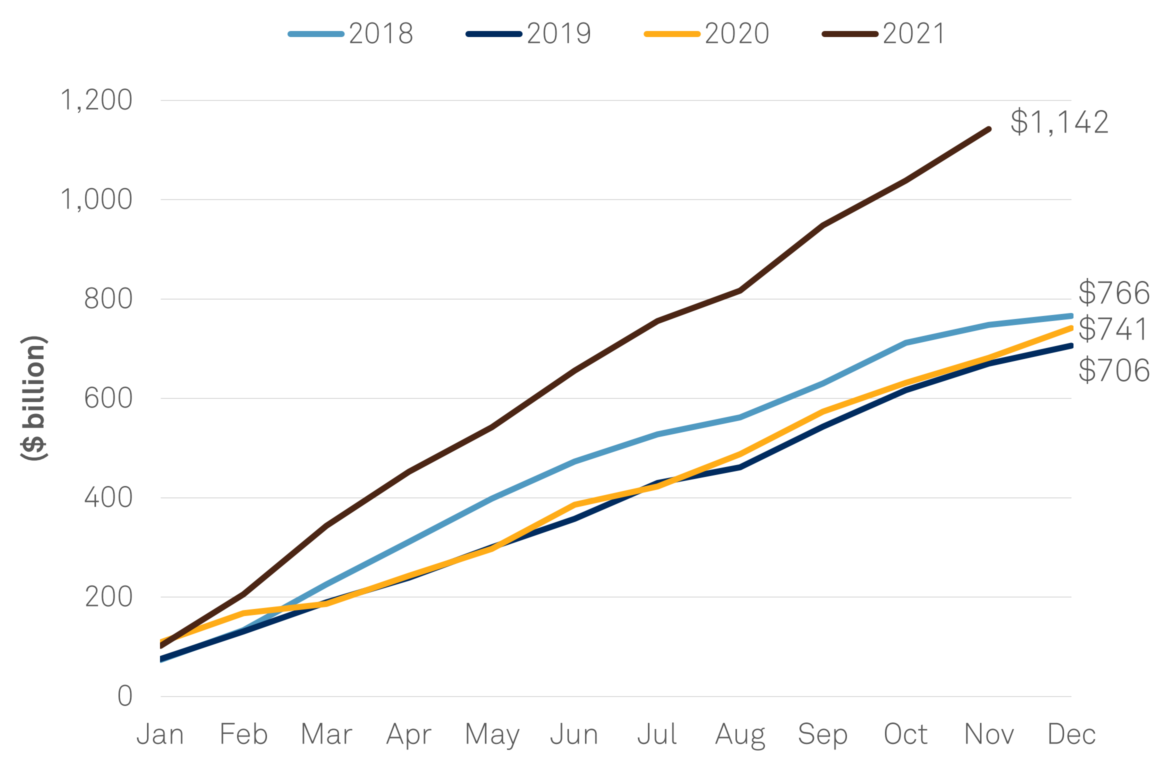
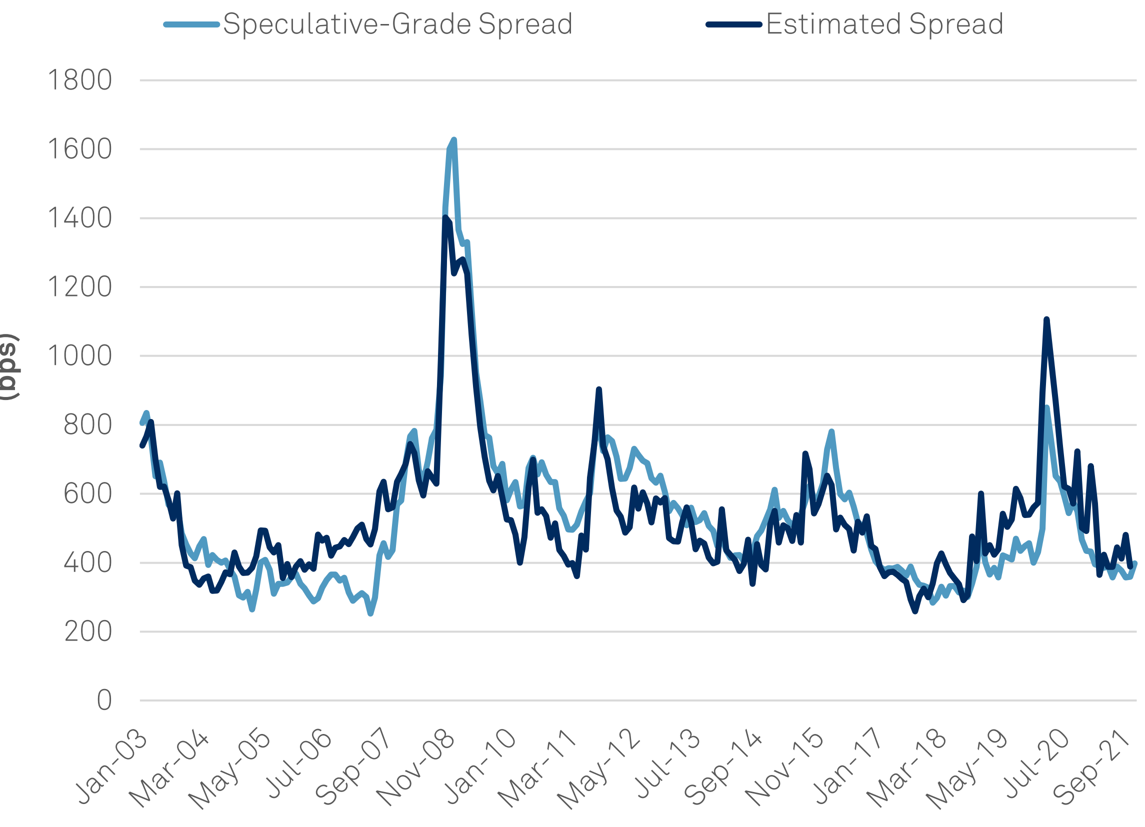


Chart displays combined speculative-grade bond, and leveraged loan issuance. Data through Nov. 30, 2021. Sources: S&P Global Ratings; Refinitiv; LCD, an offering of S&P Global Market Intelligence.

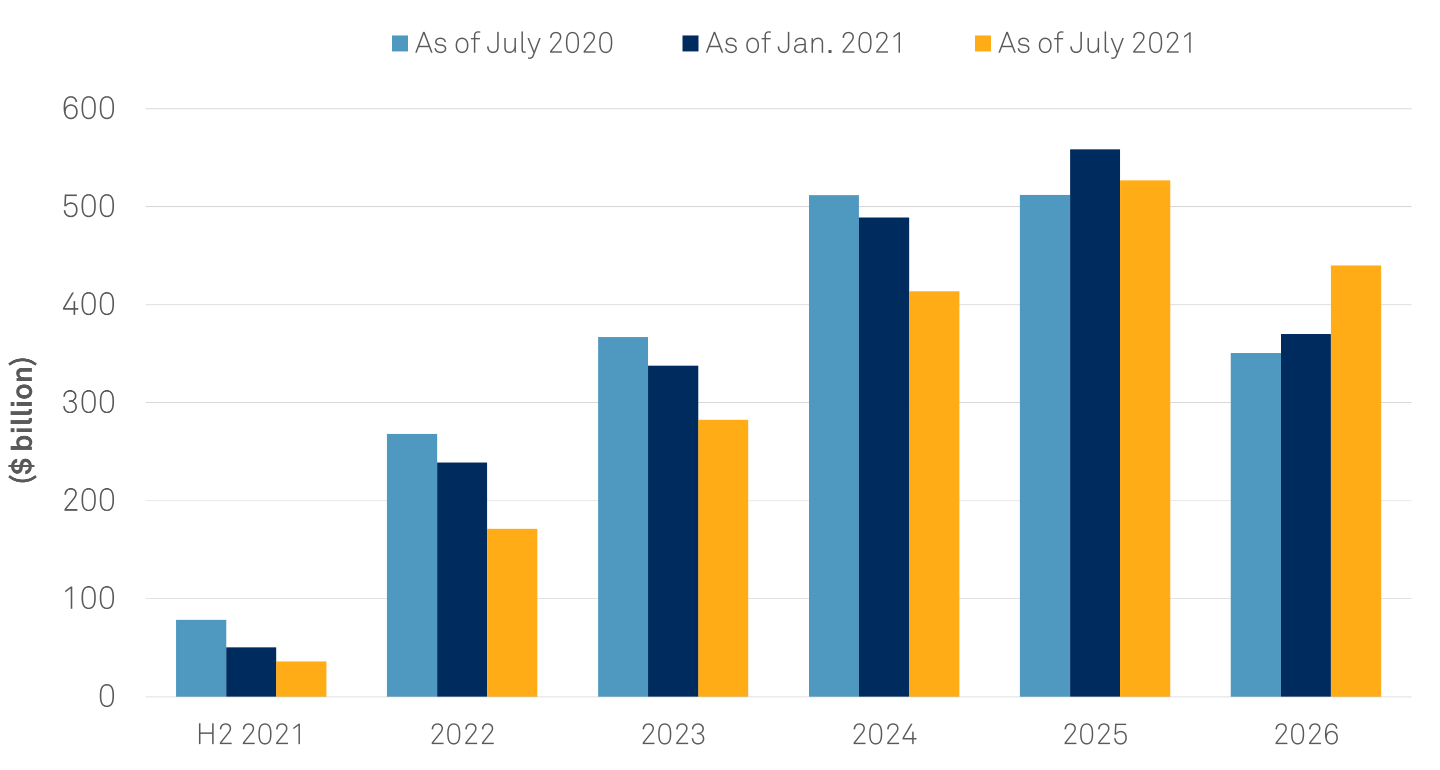
Market Pricing Implies Some Excess Optimism In Fixed Income As Omicron Threat Grows



Data through Nov. 30, 2021. Source: S&P Global Ratings.

Financing Conditions | Upcoming Speculative-Grade Maturities Sharply Reduced In The Past Year

U.S. Speculative-Grade Nonfinancial Corporate Maturity Wall



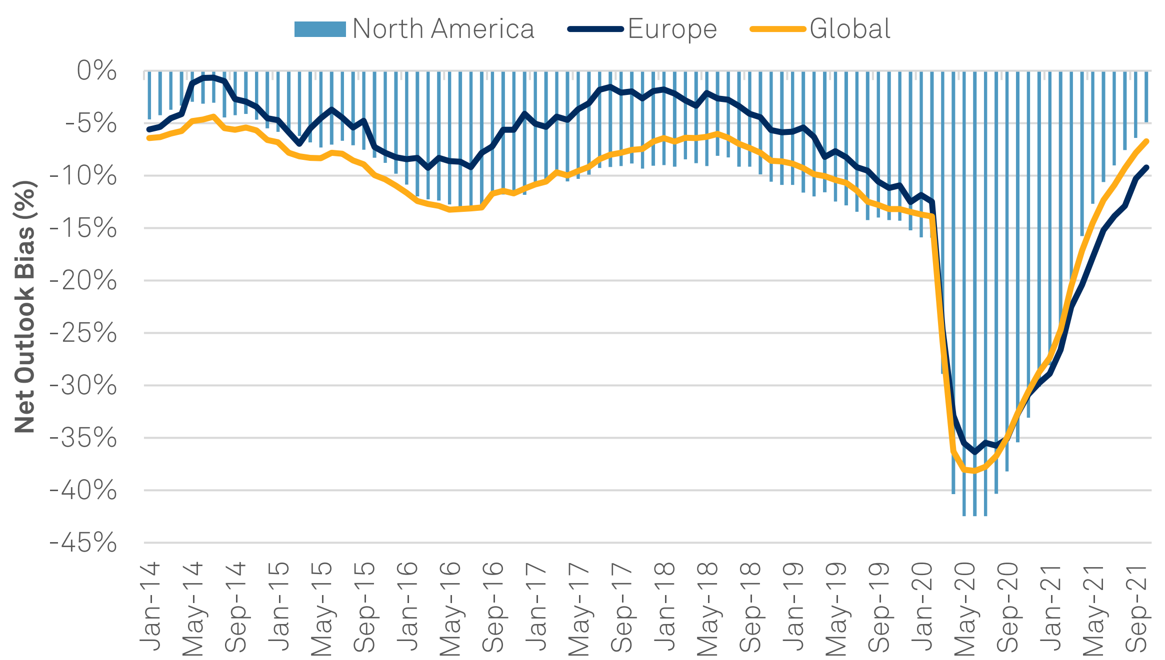
- **Near term**: Companies have reduced speculative-grade maturities in the next 18 months (second half of 2021-2022) by 40%, to $208 billion.
- **Medium term:** Speculative-grade debt maturities from 2023-2024 also declined by 21% in the past year.
- **Longer term:** Spec-grade maturities in 2026 rose 26% as companies lengthened their maturity profile with new issuance.

Note: Includes bonds, loans, and revolving credit facilities that are rated by S&P Global Ratings on the respective report date. Source: S&P Global Ratings.

Ratings Trends | Ratings Outlooks Improve, But Risks Remain

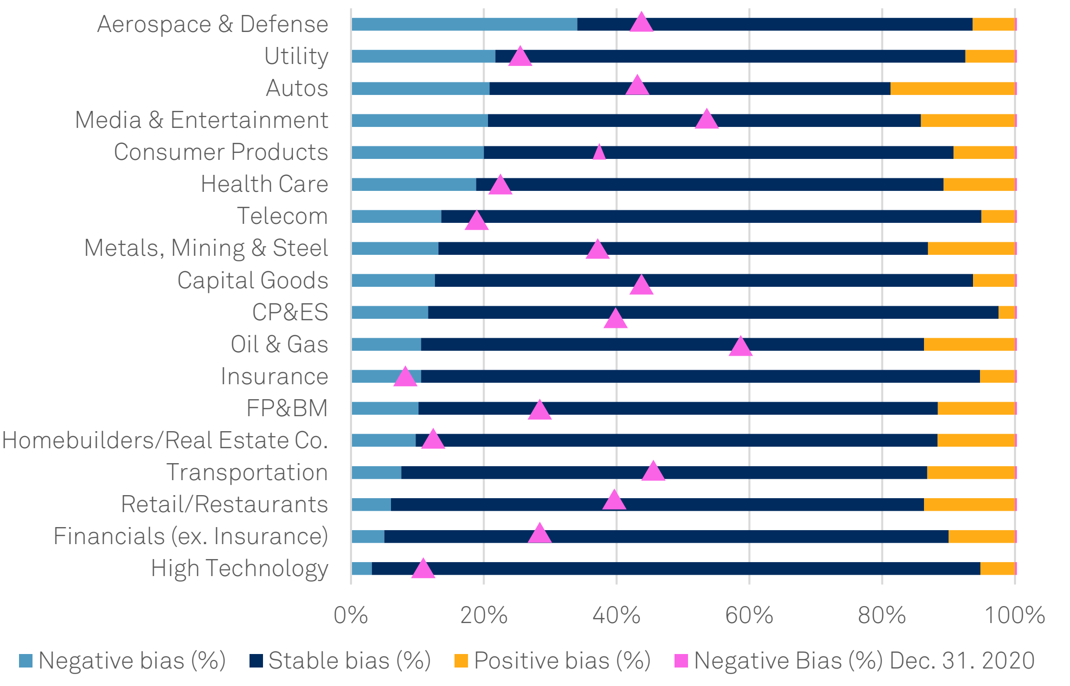
- The North American net outlook bias has narrowed significantly from the pandemic peak of -42%, to just -5% in November.
- Downgrade potential has improved across all sectors, with the most marked outlook improvement in the oil and gas, transportation, and retail sectors. But sectors including aerospace and defense, utilities, and autos still reflect somewhat elevated downgrade risk.
- Still, the ratings distribution among U.S. nonfinancial corporate borrowers is heavily spec-grade (63%)—among which 10% of borrowers are in the 'CCC' category and 36% at 'B-' or below.

North American Ratings Net Outlook Bias (%)



Net outlook bias is defined as negative bias (%) subtracted from positive bias (%). Datafrom Dec. 31, 2013 to Nov. 11, 2021, and includes nonfinancial corporates, financial institutions, and insurance. Source: S&P Global Ratings.

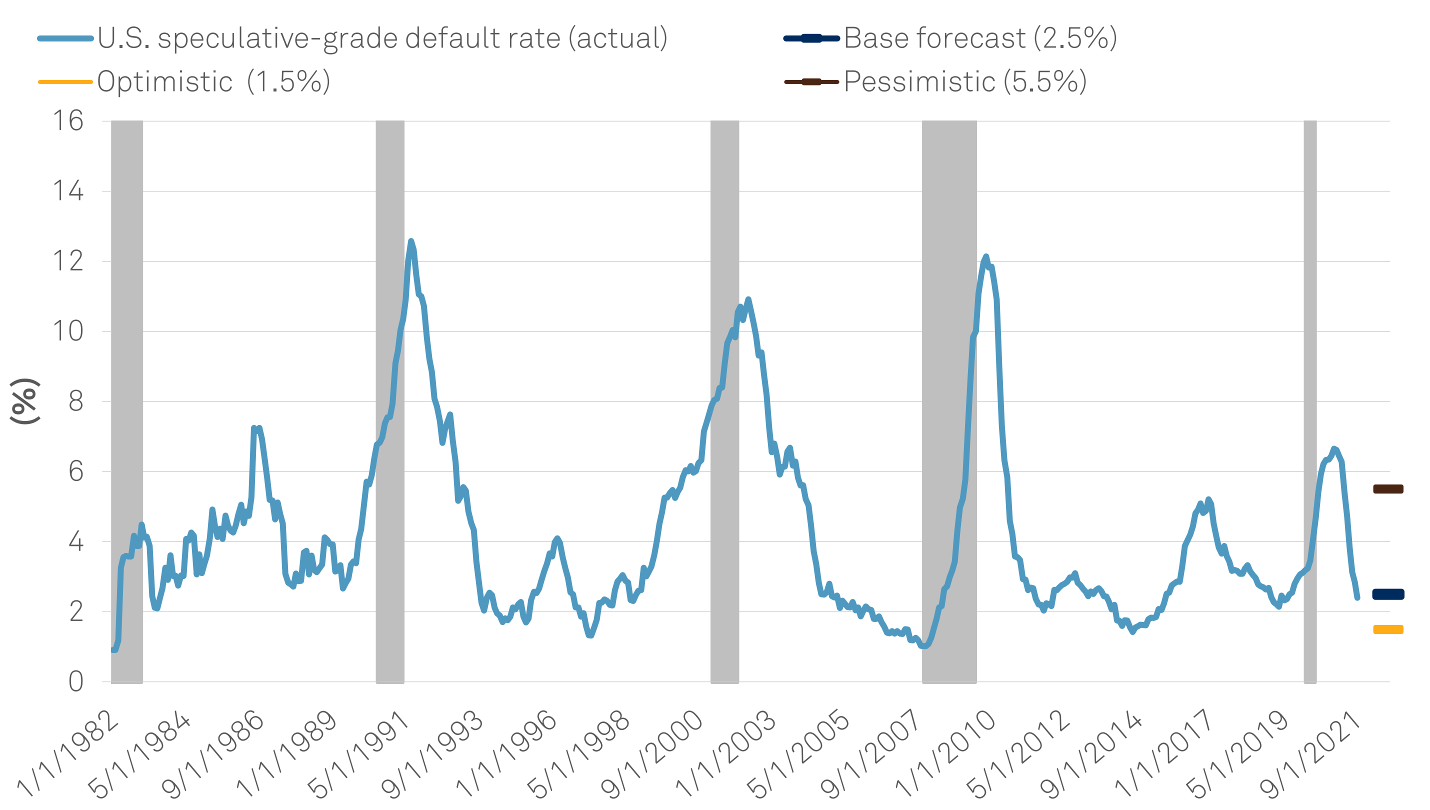
North American Nonfinancial Corporate Bias



Data as of Nov. 11, 2021. CP&ES—Chemicals, packaging and environmental services. FP&BM—Forest products and building materials. Source: S&P Global Ratings.

Ratings Trends | Defaults Likely To Remain Low Through 2022

U.S. Trailing-12-Month Speculative-Grade Default Rate And September 2022 Forecast



Shaded areas are periods of recession as defined by the National Bureau of Economic Research. Sources: S&P Global Ratings and S&P Global Market Intelligence's CreditPro®. See The U.S. Speculative-Grade Corporate Default Rate Could Reach 2.5% By September 2022, Nov. 16, 2021.

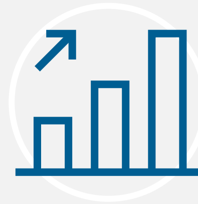
- We expect the U.S. trailing-12-month speculative-grade corporate default rate to reach 2.5% by September 2022 from 2.4% in September 2021.
- Almost all near-term indicators of future defaults suggest a still low default rate ahead, with credit metrics stabilizing, continued favorable lending conditions, over $1 trillion in spec-grade issuance this year, and a strong economic rebound expected next year.
- However, a growing list of risks could push a still-weak rating distribution to produce more defaults: persistent inflation, possible policy missteps, a very high proportion of covenant-lite loans, and potential COVID-19 mutations, to name a few.

U.S. Debt Ceiling

- On Oct. 14, President Biden signed legislation to raise the government's debt ceiling by $480 billion (to reach $28.9 trillion), effectively extending the ceiling till Dec. 3, coinciding with the deadline for funding the U.S. government.
- The U.S. Treasury resumed issuing debt but reached the new ceiling by the end of October and started undertaking "extraordinary measures" that allow it to service its debt.
- Treasury announced it would likely exhaust its fiscal capacity by Dec. 15th, based on its projected cashflows. (S&P does not make any such calculation on its own, but other organizations—like CBO—calculate that the Treasury will run out of cash before the end of December).
- We expect Congress will continue to engage in brinksmanship with the debt ceiling but will address it on time, either raising it or suspending it, understanding that the consequences on the financial markets of not doing so will be severe.
- During the last decade, Congress has passed legislation (and the president has signed it) to raise or suspend the debt ceiling on six occasions (2011, 2013, 2017, 2018, 2019, and 2021) during a similar impasse.
- Congress can raise or suspend the debt ceiling by using a Reconciliation resolution (needing a simple majority in both the Senate and the House) or by ordinary legislation (effectively needing at least 60 out of 100 votes in the Senate). Both parties are using the debt ceiling as a tool for either forcing or blocking the passage of other legislation.
- It would be unprecedented in modern times for an advanced, wealthy country such as the U.S. to default on its sovereign debt. In the event of such a default, our Criteria would prescribe a lowering of the U.S. rating to Selective Default (SD). After the default is cured, a committee would need to consider the new circumstances and determine a rating accordingly.

Source: S&P Global Ratings.

U.S. Public Finance | Strong Economic Growth And Federal Support Bode Well For USPF Credit Quality



Long-Awaited IIJA Provides $550 Billion In USPF-Related Spending

- Issuers across USPF will benefit from support for traditional infrastructure needs like roads and bridges, as well as funding for emerging risks related to climate resiliency, energy transition, and cybersecurity.
- Infrastructure funding from IIJA frees up budget space for some issuers who would otherwise make capital investments from operating revenue, allowing for greater stability over the long term.
- Funding from IIJA adds to the billions of dollars in federal aid already received from prior rounds of pandemic-related stimulus, supporting both short- and long-term needs.

ESG Remains Front And Center Across All Sectors

- Given the frequency and severity of hurricane, drought, flooding, and wildfire activity this year, issuers will need to address ongoing storm hardening to prepare for coming years.
- Without mitigation efforts, historic Western U.S. drought and related water supply challenges will pressure some municipal utilities, irrigation districts, and local governments.
- Preparedness for future weather and climate disruptions is critical for issuer credit stability over the long term; focus on the “S” and “G” of ESG may not be visible to the naked eye but are also imperative.

Strong Economy And Federal Stimulus Provide Foundation For Credit Stability In 2022…

- Stable credit environment expected in the near term as the economy continues to expand, but lack of labor availability presents a growing challenge for many issuers.
- Year-over-year revenue growth remains strong for most states, and continued strength in the housing market should contribute to healthy property valuation growth for many local governments.
- Inflation and supply chain disruptions affecting consumers have not led to direct USPF credit deterioration to date.

…But Some Lingering Uncertainties Remain

- The pandemic lingers and thus far uneven vaccination and hospitalization rates have not led to stark differences in regional economic recovery across the U.S., but winter spikes could create more pressure.
- Delayed return to office could have implications for the downtown core in urban centers and transportation providers; could also affect sales and property taxes over the medium term.
- Revenue softness for some business and leisure-related hospitality-backed debt, like convention centers, remain the exception rather than the norm.

Source: S&P Global Ratings.

Nonfinancial Corporates | Rising Costs Unlikely To Weigh Too Heavily On Corporate Credit Quality, Though Pressures May Persist

Average EBITDA Margins in 2022 vs. 2021

Question: Reflecting your assumptions for costs, product mix and any other relevant factors, how do you expect average EBITDA margins to develop for 2022 versus 2021?

Cost Pass-through Ability

Question: How easy is it to pass on cost increases?

	Rise a lot	Rise moderately	Rise a little	Fall a little	Fall moderately	Fall a lot
Very easy		• Out-of-Home Entertainment	• Paper & Packaging • Regulated Utilities	• Consumer Products • Metals & Mining • Retail & Restaurants		
Somewhat easy	• Airlines • Cruise • Lodging	• Aerospace & Defense • Capital Goods	• Business & Consumer Services • Leisure Manufacturing • Oilfield Services • Pharma • Technology	• Autos • Building Materials • Chemicals • Engineering & Construction • Freight Transportation • Gaming • Homebuilders & Developers • Telecom		
Impossible to generalize			• Oil and Gas E&P	• Midstream Energy		
Somewhat difficult				• Healthcare Services		
Very difficult						• Film and TV Programming Production

Source: S&P Global Ratings' corporate ratings sector analysts were surveyed with between Nov. 1 and Nov. 14, 2021.

- Balancing the tension between surging demand for many products and services vs. the sharp rise in input prices amid supply disruptions is a primary concern for many North American corporates.
- For many, pent-up demand outweighs escalating costs, allowing for cost pass-throughs and profit margin support. But not all sectors/companies have been able to pass on higher costs.
- Looking ahead, most sectors will likely see rising labor and non-labor costs next year—with supply bottlenecks and labor shortages only easing in the second half of 2022.
- The new omicron variant is a stark reminder that the COVID-19 pandemic is far from over. We can expect a precautionary stance in markets, and short-term containment measures put in place by governments. These could reverse the progress towards resolving supply chain disruptions.

Many N.A. Sectors Expect Supply Bottlenecks And Labor Shortages To Only Ease In The Second Half Of 2022

Question: If your sector is being affected by or benefitting from supply chain and cost issues, how long do you expect the most important effect to persist?

This Year Only

- Pharmaceuticals

To End H1 2022

- Capital Goods
- Lodging
- Midstream Energy
- Telecommunications

To End H2 2022

- Aerospace & Defense
- Airlines
- Autos
- Building Materials
- Chemicals
- Consumer Products
- Cruise
- Engineering & Const’n
- Freight Transportation
- Gaming
- Healthcare Services
- Leisure Manufacturing
- Metals & Mining
- Paper & Packaging
- Regulated Utilities
- Retail & Restaurants
- Technology

Into 2023

- Business & Consumer Services
- Homebuilders & Developers

H1 H2 H1 H2 H1 H2

2021 2022 2023

Source: S&P Global Ratings' corporate ratings sector analysts were surveyed with between Nov. 1 and Nov. 14, 2021. See Supply Chain Strains and Rising Costs Will Pressure Profitability in 2022, Nov. 18, 2021.

Structured Finance

North America Structured Finance Sector Trends (12-Month Outlook) Q1 2022

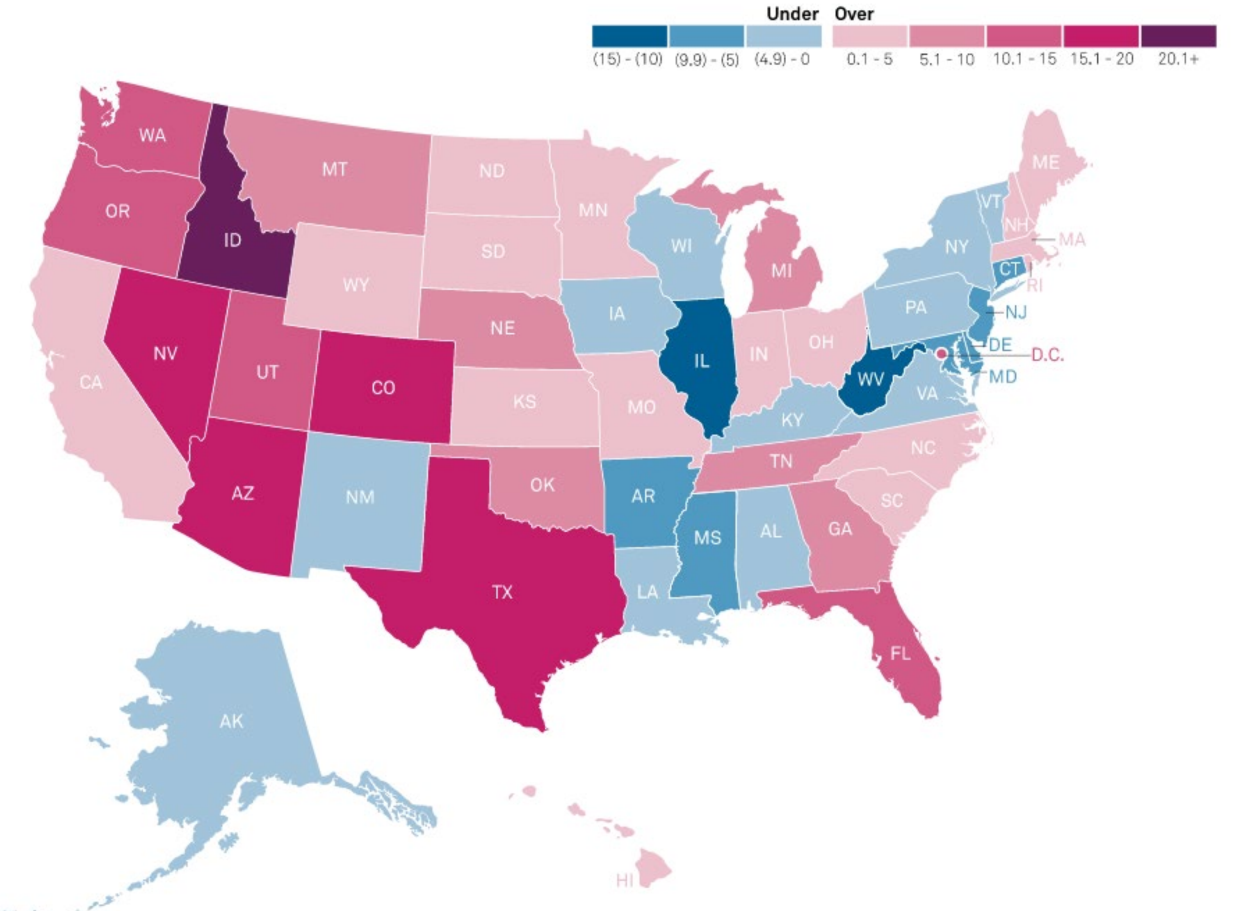
	Collateral Performance Outlook	Rating Trends
Residential mortgages		
RMBS	Somewhat Weaker	Stable
RMBS - Servicer Advance	Somewhat Weaker	Stable
Commercial mortgages		
CMBS - N.A. Conduit/Fusion	Somewhat Weaker	Stable to Negative
CMBS - Large Loan/Single Borrower	Somewhat Weaker	Stable to Negative
CMBS - Large Loan/Single Borrower (Retail)	Weaker	Stable to Negative
CMBS - Large Loan/Single Borrower (Lodging)	Somewhat Weaker	Stable to Negative
CMBS - Large Loan/Single Borrower (office)	Somewhat Weaker	Stable to Negative
Asset-backed securities		
ABS - Prime Auto Loans	Somewhat Stronger	Stable to Positive
ABS - Subprime Auto Loans	Stable	Positive
ABS -Auto Lease	Somewhat Stronger	Stable
ABS - Auto Dealer Floorplan	Stable	Stable
ABS - Credit Cards	Somewhat Weaker	Stable
ABS - Unsecured Consumer Loans	Somewhat Weaker	Stable to Negative
ABS - FFELP Student Loan	Somewhat Weaker	Stable
ABS - Private Student Loan	Stable	Stable
ABS - Commercial Equipment	Stable	Stable
Asset-backed Commercial Paper	Somewhat Weaker	Stable
Structured credit		
CLOs	Somewhat Weaker	Stable
Timeshares	Stable	Stable
Small Business	Somewhat Weaker	Stable
Tobacco	Somewhat Weaker	Stable
Transportation - Aircraft	Somewhat Weaker	Stable to Negative
Transportation - Container	Stable	Stable
Transportation - Railcar	Stable	Stable
Whole Business	Stable	Stable
Triple Net Lease	Stable	Stable

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

- **The structured finance credit picture remains stable-to-improving**, buoyed by gains in employment and wages, robust economic growth, and a relatively positive picture for U.S. consumers, despite inflation pressures.
- **LIBOR transition.** More than 90% of U.S. SF exposure is concentrated among the CLO, legacy RMBS, and student loan ABS sectors.
- **Most caution within CMBS.** Class B and C malls in secondary and tertiary locations continue to struggle. The lodging sector is improving, though group/business demand has lagged. Return-to-office plans will likely start to emerge in earnest in 2022, which should buoy lodging (and aircraft) and shed more light on the outlook for office.
- **CLOs** saw record issuance this year. We are watching a modest deterioration in recovery ratings that could affect some pre-pandemic CLOs, and a historically high proportion of single 'B-' rated obligors in recent vintages.

U.S. RMBS | The Shift From Under To Overvalued

RMBS Over/Under At State Level



Source: S&P Global Ratings. See The Shift From Under To Overvalued: What It Means For U.S. RMBS, Oct. 29, 2021.

- U.S. home prices have made significant gains. We have updated the home value assessments we use when evaluating mortgage pools backing certain residential mortgage-backed securities.
- Nationwide, we estimate housing is about 5% overvalued. However, the picture varies at the state level and by core-based statistical area (CBSA). That is, some states and CBSAs are overvalued while others are undervalued.
- The impact of home values on a residential mortgage pool is based on the specific CBSAs and their geographic representation in that pool.

Financial Institutions

Banks

- We continue to have confidence in the health of the U.S. banking system. Bank earnings—which have risen sharply in 2021 on reserve releases—should fall in 2022 as provisions for credit losses climb from the negative levels of 2021. However, pre-provision profitability should rise on higher net interest income due to an acceleration in loan growth and some rise in rates.
- Bank asset quality looks set to remain in good shape, and capital ratios will edge down towards pre-pandemic levels. Funding and liquidity will remain in good shape but are unlikely to improve further given the Fed's tapering and potential rate hikes.
- Competitive pressures from advances in fintech and the shadow banking system will likely continue to drive significant M&A activity.

Finance Companies

- We think the likelihood of substantial further deterioration in the loan portfolios of commercial real estate finance companies has lessened. Nevertheless, there may be property-specific issues to work through.
- We now have stable outlooks on all business development companies we rate. Overall portfolio valuations have substantially recovered from the depths of the pandemic-related shutdowns.
- Performance in the consumer finance segment was surprisingly resilient during the pandemic and has remained strong.

Asset Managers

- Our outlook on traditional and alternative asset managers remains stable. This reflects our belief that secular industry headwinds will continue to be offset by higher asset prices, supporting assets under management (AUM) levels and margins.
- Low interest rates continue to fuel the active strategic pairings between life insurance companies and asset managers. Some of these asset managers will now become more exposed to the risks that annuity providers face; depending, too, upon the asset manager's willingness to provide some form of support to the insurer under certain stress scenarios.

Source: S&P Global Ratings.

Insurance

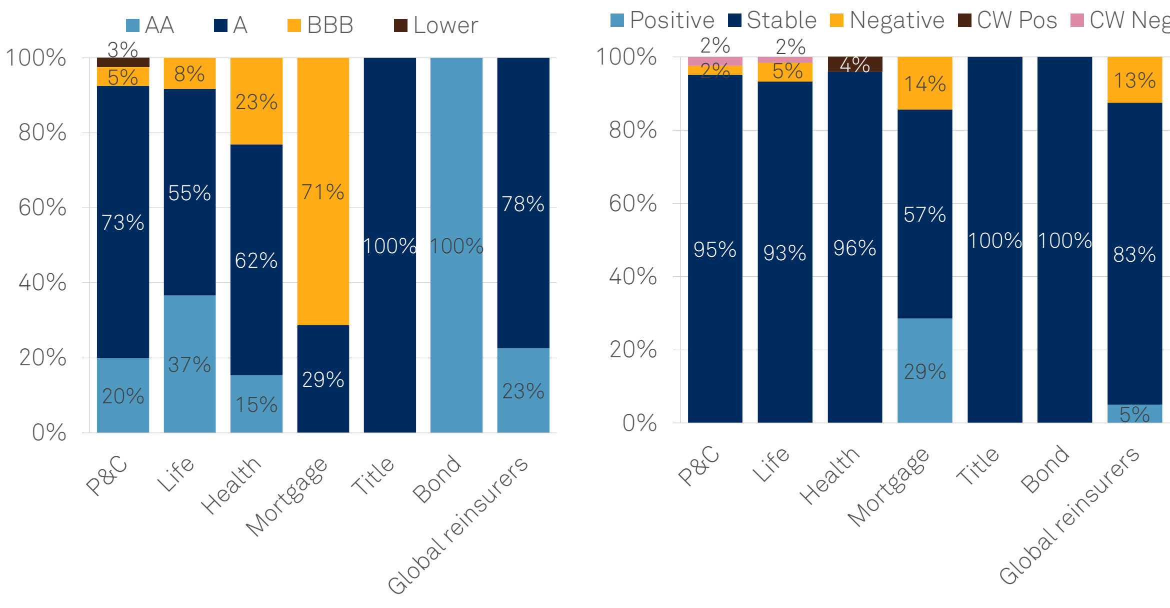
- Ratings activity was very limited in the fourth quarter 2021 with no assessed changes to current business conditions. Our 'somewhat stronger' business conditions outlook assessment sustained for the life, health, and global reinsurance sectors.
- Overall, the average financial strength rating for the core North American insurance portfolio (life, health, property/casualty) is at the upper end of the strong ('A') category. A very high percentage (>90%) of our ratings maintain stable outlooks.
- Major rating factors include natural catastrophes, investment yield, regulatory and legislative policy, and competitive conditions.
- Accommodative financial conditions combined with valuation (life) and intent to diversify beyond insurance (health) are providing ongoing support for consolidation.
- Balance-sheet strength remains supportive of credit quality for the portfolio, providing a measure of protection from risks.

North America Insurance Sector Trends Q1 2022

	Current Business Conditions	Business Conditions Outlook	Sector Outlook
Life Insurers	Satisfactory	Somewhat Stronger	Stable
Health Insurers	Satisfactory	Somewhat Stronger	Stable
Property & Casualty Insurers	Satisfactory	No Change	Stable
Global Reinsurers	Weak	Somewhat Stronger	Negative
Bond Insurers	Satisfactory	No Change	Stable
Title Insurers	Satisfactory	No Change	Stable
Mortgage Insurers	Satisfactory	No Change	Stable

Note: Business conditions and sector outlook are for the next 12 months. Source: S&P Global Ratings.

Rating And Outlook Distribution



Data as of Oct. 31, 2021. CW Pos--CreditWatch with positive implications. CW Neg--CreditWatch with negative implications. Source: S&P Global Ratings.

S&P Global Ratings

Appendix 1: Economic Data And Forecast Summaries

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

	2020	2021f	2022f	2023f	2024f
Real GDP (year % ch.)	(3.4)	5.5	3.9	2.7	2.3
Real consumer spending (year % ch.)	(3.8)	8.0	3.8	2.5	2.5
Real equipment investment (year % ch.)	(8.3)	13.1	2.1	4.4	5.3
Real nonresidential structures investment (year % ch.)	(12.5)	(7.9)	0.6	6.3	5.4
Real residential investment (year % ch.)	6.8	8.6	(2.8)	0.6	2.6
Core CPI (year % ch.)	1.7	3.4	3.5	2.6	2.3
Unemployment rate (%)	8.1	5.4	4.0	3.7	3.4
Housing starts (annual total in mil.)	1.4	1.6	1.5	1.5	1.5
Federal Reserve's fed funds policy target rate range (year-end %)	0-0.25	0-0.25	0.25-0.50	1.00-1.25	1.5-1.75

Note: All percentages are annual averages, unless otherwise noted. Core CPI is consumer price index excluding energy and food components. f—forecast. Sources: Bureau of Economic Analysis, Bureau of Labor Statistics, the Federal Reserve, Oxford Economics, and S&P Global Economics' forecasts.

Canada – S&P Global Ratings Economic Outlook

	2020	2021f	2022f	2023f	2024f
Real GDP (year % ch.)	(5.3)	5.0	3.7	2.7	2.1
Household real final consumption (year % ch.)	(5.9)	4.1	4.8	3.0	2.2
Real equipment investment (year % ch.)	(17.4)	7.5	8.6	5.4	3.2
Real nonresidential structures investment (year % ch.)	(11.3)	(4.7)	6.3	5.3	3.2
Real residential investment (year % ch.)	4.1	18.1	(3.4)	(0.2)	1.7
Core CPI (year % ch.)	1.1	2.2	2.5	1.7	2.0
Unemployment rate (%)	9.6	7.6	6.3	5.9	5.6
Housing starts (annual total in thousands)	219.0	275.3	239.2	230.0	227.5
MLS house price index (year % ch.)	8.5	21.0	2.8	0.0	1.7
Government of Canada 10-year bond yield (%)	0.8	1.4	2.3	2.9	3.1
Bank of Canada policy rate (year-end %)	0.6	0.3	0.6	1.1	1.6

Note: All "year % ch." are annual averages percent change. Core CPI is consumer price index excluding energy and food components. f—forecast. Sources: Statistics Canada, Oxford Economics, and S&P Global Economics' forecasts.

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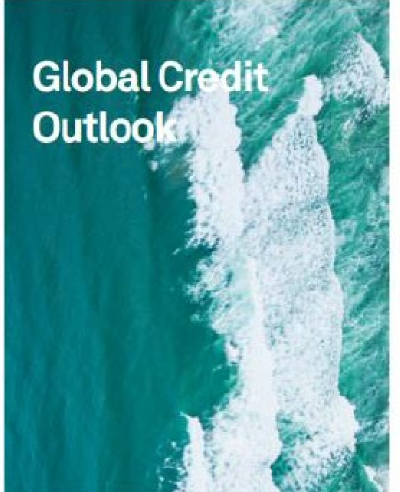

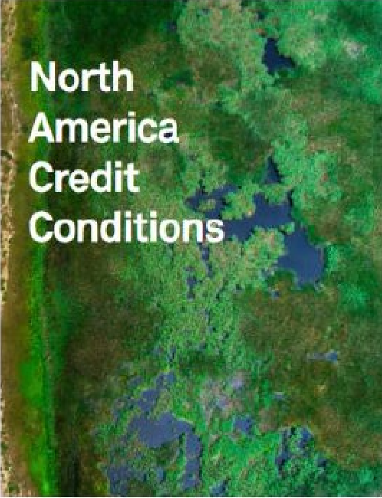

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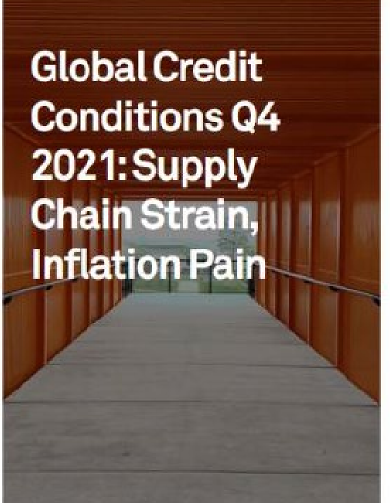

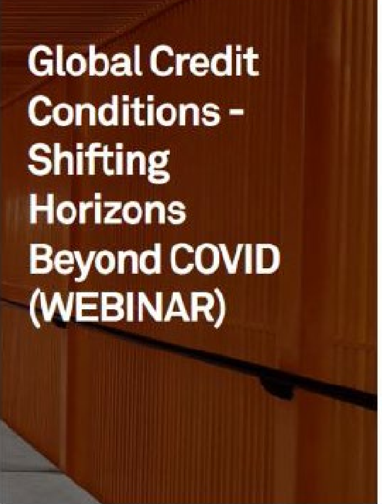

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