Global Credit Conditions Special Update:

Geopolitical, Inflation, And Rate Risks Rise

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Key Takeaways

- Downside risks to global credit conditions are escalating—in particular, geopolitical tensions, persistent inflation, and the promise of higher borrowing costs.
- The prospects for global economic growth have softened (if only modestly), and central banks' ability to curb reflation without impeding the post-pandemic recovery is paramount.
- A rapid and volatile market repricing would hurt lower-rated borrowers. Emerging markets most reliant on external financing are vulnerable to volatile capital flows and fragile investor sentiment, while those with material foreign currency borrowings could suffer from higher financing costs.

S&P Global Ratings monitors global credit conditions and their potential implications on ratings, and our Credit Conditions Committees publish regional and global reports each quarter. Significant changes in conditions since our most recent report require an update on the global risks we are monitoring (see "**Global Credit Outlook 2022: Aftershocks, Future Shocks, And Transitions**," published Dec. 1, 2021). In particular, we have added and updated our assessment of risks focused on geopolitical tensions, and we have adjusted the risk trend on rising borrowing costs to "worsening," as major central banks prepare to embark on a cycle of monetary-policy tightening. These updates do not reflect a change to our base case, but rather represent our view of new or escalating risks that could act as drags on our assumptions in 2022 (see "**Economic Outlook Q1 2022: Rising Inflation Fears Overshadow A Robust Rebound**," published Nov. 30, 2021).

As pandemic-related disruptions continue to weigh on business activity and economic-growth prospects in many regions, additional downside risks to global credit conditions are amplifying—not the least of which are rising geopolitical tensions and the prospect for higher borrowing costs (see table 1).

Tensions between Russia and NATO have escalated in recent weeks, with the former deploying reportedly 130,000 troops at the country's border with Ukraine and warning that it's prepared to use military means to defend its interests in the region. Even if an armed conflict is avoided, the disagreements between Russia and NATO over security concerns will likely persist (see "**Possible Credit Consequences Of Escalating Russia-West Tensions Over Ukraine And Further Sanctions Against Russia**," published Feb. 8). As a deterrent, the U.S. and the EU have threatened a variety of sanctions that, among other things, could diminish Russia's role in the global economy. The imposition of strict sanctions, along with any countermeasures from Russia, could hinder the operations of exposed borrowers and have broader ramifications, such as a temporary energy price shock in Europe—which could exacerbate inflationary pressures.

Meanwhile, as China strives to be less reliant on foreign markets and technology, a strategic confrontation with the U.S. shows no signs of abating. A further intensification of tensions over the South China Sea region could weigh on trade, investments, and financial transactions for both and other economies—with some sectors suffering disproportionately.

It remains to be seen whether sporadic omicron-related disruptions and new lockdowns across the globe will materially crimp the flow of goods, but, in any event, economies have generally become more resilient to each wave of the pandemic. Our central assumption remains that the omicron variant will chip away at some of this year's expected economic expansion but doesn't pose a material threat to global growth.

The prospects for global economic growth have softened somewhat since our most recent forecast round, but the change is modest. High-frequency indicators such as hotel bookings and air travel weakened in December and January, but there was still a strong finish to 2021. All three major economies—the U.S., China, and the eurozone—posted slightly higher-than-expected growth last year, with much of that reflecting better results in the fourth quarter.

Looking ahead, more consequential than omicron will be the success (or failure) of central bank policy in slowing inflation without halting the post-pandemic recovery in its tracks. In response to continued upside surprises in inflation, the U.S. Federal Reserve has pivoted away from characterizing above-target inflation as "transitory" and acknowledged that some components of price pressures are demand-driven and thus within its area of control. The Fed announced that it will accelerate the reduction of its asset purchases (known as tapering) and will now finish by March. The lift-off of its policy rate from "effective zero" will follow shortly. S&P Global Economics now expects six increases in the benchmark federal funds rate this year, with five more to follow in 2023-2024 (see "**The January Jobs Report: Resisting Omicron And Climbing Higher**," published Feb. 4).

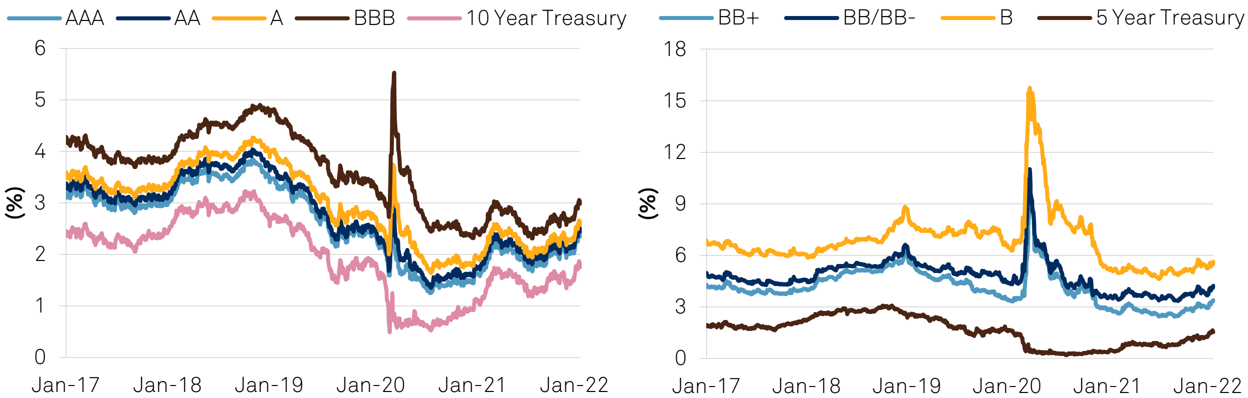
It's worth noting that this is an instance when the Fed's indicated moves were largely anticipated by financial markets. As a result, the repricing—reflected in values, spreads, and volatility—in response to the Fed's pivot has been fairly modest, at least in the debt markets. The next few months of inflation data will be critical, as they will determine whether the priced-in pace of Fed tightening would need to accelerate with the attendant risks of a more disruptive market adjustment.

Financial markets have also brought forward their bets on policy tightening by the European Central Bank (ECB), coinciding with ECB President Christine Lagarde saying that the bank won't exclude the need for a rate increase this year. The Bank of England, meanwhile, has already raised rates twice. (By contrast, the People's Bank of China unexpectedly cut borrowing costs in mid-January in an effort to guard against an economic slowdown.)

From a borrowing standpoint, whether 2022 will be characterized by restrictive financing conditions along with more downgrades and defaults remains an open question. In the U.S., secondary-market corporate yields have risen since the start of the year but remain below where they've been for most of the past five years (see chart 1). In fact, roughly speaking, corporate yields could widen another 100 bps and still be around the levels of the benign period of late 2017-2018.

Chart 1

U.S. Secondary Market Corporate Bond Yields Are Rising, But Remain Favorable



Data as through Jan. 21, 2022. Source: S&P Global Ratings.

Still, a rapid and volatile market repricing would hurt lower-rated borrowers, in particular. Emerging markets most reliant on external financing are vulnerable to volatile capital flows and fragile investor sentiment, while those with material foreign currency borrowings could suffer from higher financing costs. That said, emerging markets are, by many metrics, largely better positioned to face the upcoming Fed tightening cycle than they were in 2015 (see "**How Prepared Are Emerging Markets For The Upcoming Fed Policy Normalization?**," published Jan. 27).

Even with an orderly reflation shepherded by measured central bank moves, the drying up of government support in many economies could expose the operational and structural headwinds many borrowers face. Companies are still learning how to best handle pandemic-related pressures, as well as the more permanent shifts in business dynamics that were accelerated (rather than caused) by COVID. If the recovery in companies' income starts to wobble, some borrowers may find their operating environments and debt burdens unsustainable, resulting in weaker credit quality.

Top Global Risks

Table 1

Risk level			Risk trend		
Very high	High	Elevated	Improving	Unchanged	Worsening

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.

Rising borrowing costs, record-high debt, curb financing and threaten credit quality
As many major central banks, including the Fed, look set to aggressively raise policy interest rates (or have already begun to do so), investors could demand greater returns amid greater uncertainty. Higher benchmark rates, combined with a normalization/widening of spreads, could end a historic run of favorable financing conditions. This is particularly concerning against the backdrop of soaring global debt that has reached $225 trillion. A rapid and volatile market repricing—affecting debt-servicing costs and funding access—would hurt lower-rated borrowers, in particular. Emerging markets most reliant on external financing are vulnerable to volatile capital flows and fragile investor sentiment, while those with material foreign currency borrowings could suffer from higher financing costs. Corporates exposed to operational and structural headwinds, and highly indebted small and medium-sized enterprises may be unable to rebuild revenues and earnings before their financing costs rise to more normal levels.

Inflationary pressures persist, hitting profits
With inflation in many regions running hotter and for longer than economists expected—fueled, in part, by persistent global supply bottlenecks—borrowers in many sectors will likely continue to face input cost pressures that could increasingly erode margins and weigh on credit quality for some, particularly as growth slows.

Geopolitical and domestic tensions worsen, weigh on economic and business conditions
Amplified geopolitical tensions—in particular, Russia's dispute with NATO over Ukraine—raise the risk of restricted trade and capital flows, and could weigh on economic growth. The imposition of strict sanctions on Russia, along with any countermeasures, could hinder operations of exposed borrowers and have broader ramifications, such as a temporary energy price shock in Europe. The strategic confrontation between the U.S. and China, and a further intensification of tensions over the South China Sea region, could impede trade and investment regionally and globally. Meanwhile, internal political stresses, in some cases reflecting widening socioeconomic gaps, will likely fuel more nationalistic and populistic policies, which could threaten economic efficiency and social stability.

China policy stance clouds credit and growth trajectories
The government's intent to reduce income disparity and prioritize social values ("common prosperity") and to reduce dependence on foreign technology and economies ("dual circulation") increases the likelihood of lower economic and income growth. China's policy and economic developments affect others reliant on the regional colossus for exports or finance (e.g., emerging markets) and imports (e.g., component parts).

Renewed pandemic-related disruptions damp economic recovery
As the omicron variant shows, the risk remains that sporadic COVID-related disruptions and lockdowns around the world will continue to crimp the flow of goods. Even without reinstated social restrictions, increased wariness among consumers could hit consumer-facing sectors particularly hard. The emergence of new, more-severe variants that evade existing immunity can't be ruled out. Any uncontrolled resurgence of the virus could hamper the global economic recovery, creating a challenging credit environment for some countries and sectors.

Structural Risks

Climate change and a bumpy transition to a low-carbon economy
The transition to "net zero" has become a priority for global leaders and corporations, and asset managers and institutional investors are allocating more of their portfolios to sustainable investments. A rapid phase-out of fossil fuels to achieve net zero could be disruptive for many industries, pressuring creditworthiness. Sovereigns that depend on hydrocarbon revenues, or economies centered on highly pollutive industries, could also face pressures. On top of the increased physical risks companies and countries face from more frequent climate disasters, corporate boards and government leaders also face increased calls to show they can understand and oversee broader ESG issues—from human rights to social unrest.

Digitalization and cyberattacks disrupt business models, add to systemic risks
Increasing technological dependency and global interconnectedness means cyber risk poses a systemic threat and significant single-entity risk. As attacks become more sophisticated, new targets and methods are emerging. Organizations face the risk of criminal and state-sponsored cyberattacks, as well as disruptions caused by increasing digitalization with opaque and complex global systems.

Related Research

- Possible Credit Consequences Of Escalating Russia-West Tensions Over Ukraine And Further Sanctions Against Russia, Feb. 8, 2022

Global Credit Conditions

- Global Credit Outlook 2022: Aftershocks, Future Shocks, And Transitions, Dec. 1, 2021

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- The January Jobs Report: Resisting Omicron And Climbing Higher, Feb. 4, 2022
- How Prepared Are Emerging Markets For The Upcoming Fed Policy Normalization?, Jan. 27, 2022
- Macroeconomic Update, Jan. 20, 2022
- Economic Outlook Q1 2022: Rising Inflation Fears Overshadow A Robust Rebound, Nov. 30, 2021

2022 Outlooks Across Ratings Practices

- U.S. Corporate Credit Outlook 2022: New Year, New Risks (Beyond, Of Course, Inflation), Jan. 31, 2022
- Global Sovereign Rating Trends 2022: Despite Stabilization, The Pandemic Threatens The Recovery, Jan. 27, 2022
- Credit Outlook For U.S. Public Finance: Positive Momentum Continues, Jan. 26, 2022
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- Global Structured Finance 2022 Outlook, Jan. 12, 2022
- Global Banks Outlook 2022: Back On Course, Dec. 14, 2021
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