Global Credit Conditions
Q3 2019

Ebbing Growth, Rising Risks

October 1, 2019
Overview | Ebbing Growth, Rising Risks

Key Takeaways

– **Faltering growth:** Economic growth expectations are faltering as political and trade tensions stymie investment plans and erode confidence. Global recession remains unlikely given renewed monetary stimulus, but lower-for-longer rates are heightening financial-sector risks. Credit quality is deteriorating in cyclically-sensitive sectors.

– **Tensions:** Domestic political tensions – possible impeachment hearings in the U.S.; the Brexit imbroglio; elections and policy uncertainty in Latin America – are eliding with persistent global risks – U.S. and China trade and tech disputes; proxy conflict in the Middle East – to create a confidence-sapping climate of uncertainty. There is little prospect of immediate resolutions.

– **Policy response:** Central banks have once again reached for the monetary policy playbook with widespread reductions in interest rates and renewed unconventional stimulus. This has helped underpin financing conditions and is likely to mean low interest rates and flatter yield curves persist into 2020-21. Absent further shocks, this is likely to prevent a global recession.

– **Risks for the long term:** Nevertheless, this renewed stimulus poses longer term risks as it further encourages financial risk-taking through a hunt for yield, undermines financial sector profitability and exacerbates pension liability pressure. There is little sign that the stimulus has boosted investment intentions or confidence.
Global growth continues to slow as the weakness in manufacturing and trade with still-robust household spending persists. The main driver of this slowdown remains uncertainty around the U.S.-China relationship.

Major central banks have lowered rates to support growth and boost inflation, with actions characterized more as insurance cuts than an easing cycle.

We forecast a continued moderate pace of activity in the near-term with the balance of risks on the downside; labor market developments - still positive - will be key.

U.S.: We forecast U.S. growth to approach 2% in 2020-2021, close to its steady-state path. However, our Business Cycle Barometer shows near-term recession risks are rising. We now put the probability at 30-35% — more than twice what it was a year ago.

Europe: Key parts of the European economy are struggling – Germany, Italy and the U.K. amongst them – bringing renewed monetary easing and restarted QE. Overall, we see European growth slowing to 1.1% in next year, from 1.2% this year.

China: Activity continues to slow and we expect GDP to expand 6.2% this year. There are some signals that the Chinese authorities could allow growth to slow below 6% next year, which would be a welcome development given years of credit-fueled investment.

Source: S&P Global Economics, CEIC, Refinitiv
1. Political tensions affecting growth

Rising political tensions and heightened uncertainty, weighing on business and consumer confidence, risks undermining global growth prospects. The lengthening list of disputes includes the U.S.-China trade-technology war, Brexit, U.S.-Mexico-Canada Agreement delayed ratification, U.S.-Iran tensions, recent attack on Saudi oil facilities, and Japan-Korea technology dispute.

Economic and geopolitical policy uncertainty indices


2. Mature markets negative feedback loop

GDP growth trends (especially of U.S. and China), low inflation, inverted yield curves, and negative interest rates in Europe and Japan are worrying investors. In particular, overvaluation in financial assets and further debt accumulation risks becoming a source of instability, particularly if economic growth slows materially. Indeed, we now estimate the risk of a U.S. recession at 30%-35%.

Per cent

Source: Refinitiv
Credit Conditions | Global Top Risks

3. Trade and politics threaten Emerging Markets

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

Continued trade tensions between the U.S. and China, geopolitical and domestic policy uncertainty in many EMs have weighed on confidence and are hampering investment. A significant slowdown or outright reversal in capital flows to Emerging Markets would further weaken their economic outlook.

Non-resident portfolio flows into emerging markets

4. China’s leverage hampering rebalancing

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

China contributes at least a third of global GDP growth. The debt overhang there remains an impediment to a rebalancing of the economy. The Chinese government’s intent to deleverage the system is challenged by its desire to keep GDP growth up although the desire is showing signs of moderating.

China debt-ratio trajectory

Source: Institute of International Finance

Source: Bank for International Settlements
5. Climate change impact on economies

Environmental risk factors related to greenhouse emissions, water, waste have become more urgent global issues. The challenge from a credit viewpoint is how to manage the asymmetric risks and related costs attached to climate change and regulation.

Number of relevant natural loss events worldwide 1985-2018

Source: Munich Re NatCatSERVICE

Accounted events have caused at least one fatality and/or produced normalised losses ≥ US$ 100k, 300k, 1m, or 3m (depending on the assigned World Bank income group of the affected country).

6. Cybersecurity threats to business activity

Increasing technological dependency, global interconnectedness and rapid technological change means that cyber risk has systemic dimensions.

Widespread cloud usage across sectors highlights systemic dimension of cyber threat

Source: Cyence
Regional Highlights
Key Takeaways

- **Overall:** Credit conditions are expected to be bumpy. Despite looser monetary policy, China's slowdown and U.S.-China trade tensions are adversely affecting sentiment. This is hurting revenue and profit growth and intensifying refinancing risk.

- **What's changed:** Investor sentiment is becoming more cautious amid heightened geopolitical stress and slower economic growth.

- **Risks and imbalances:** The greatest near-term risk is the strategic conflict between the U.S. and China, with its attendant market impact. Other top risks include corporate refinancing and market liquidity, property repricing, and China's debt.

- **Financing conditions:** Headwinds have returned. Should investor sentiment sour interest spreads could rise, despite lower official rates.

- **Macroeconomic conditions:** U.S.-China trade-tech tensions have intensified and regional growth has come in below our expectations.

- **Sector themes:** Idiosyncratic factors are driving the continuing dichotomy in ratings bias trend between corporates (negative) and financials and governments (positive).
1. U.S.-China Strategic Confrontation

![Chart 1](chart1.png)

2. China credit spread trends

![Chart 2](chart2.png)

3. Property Valuation Correction

![Chart 3](chart3.png)

4. China’s Leverage

![Chart 4](chart4.png)

Asia-Pacific's Investment-Led Slowdown

Real GDP Growth Year Over Year

APAC And EM Asia Inflation Slowing

Note: PPP GDP-weighted excluding China and Vietnam due to data availability.
Source: CEIC and S&P Global Economics.

Source: CEIC and S&P Global Economics
Steel Supporting Manufacturing Growth in China

China’s Financial Conditions Index Peaked

Note: ppts = percentage points. Source: CEIC and S&P Global Economics.

Note: Average of first two components from principal component analysis of 41 variables. Quarterly data interpolated using the EM algorithm. 
Key Takeaways

- **Overall:** Weakening economic growth, political and trade tensions and ongoing tech disruption are pressuring credit quality. Renewed monetary policy efforts are likely to prevent a broader recession, but persistently low interest rates pose serious risks for financials and corporate pension liabilities.

- **What's changed:** The ECB has gone ‘all-in’ to shore up growth and underpin inflation. While the Eurozone should avoid technical recession, it is acutely vulnerable to external shocks (trade, oil).

- **Risks and imbalances:** Political risks remain at the fore, particularly global trade tensions and the increasingly vitriolic Brexit imbroglio. Greater market volatility is a growing global risk as credit risk premiums tighten in a low for longer rate environment.

- **Financing conditions:** Monetary policy appears close to the point where lower-for-longer near zero rates provides minimal stimulus, but raise downside risks for financial sector profitability.

- **Macroeconomic conditions:** Growth prospects continue to be scaled back as the manufacturing recession spreads to services and construction peaks, particularly in Germany.

- **Sector themes:** The main areas of concern are around the impact of low rates (banks, insurance), Brexit (U.K. public sector entities in particular) and slowing global growth (corporates).
Eurozone Economics | Manufacturing Recession Spreading to Services Dampening Inflation

1. New Car Registrations (3mma YoY%)

2. Weakening Sentiment Spreading From Industry

3. China Leading Producer Prices Lower Globally

4. Eurozone Govt Debt Securities Not Held by ECB


S&P Global Ratings
Eurozone | Growth Flatlining; LT Yields Grounded

2020 Eurozone GDP Forecasts Revised Lower

...10yr Bund Yields Staying Low for Longer

Source: S&P Global Ratings
No-deal Brexit

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

Our base case is that the U.K. will not leave the EU without a deal. Even so, given the government’s intention to leave the EU, a no-deal Brexit remains a meaningful likelihood, though more likely in 2020 than in 2019. A no-deal Brexit would likely push the UK economy into a recession next year and create further rating headwinds, particularly for more cyclical sectors.

Geopolitical Risk

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

Tensions between Iran and the U.S. as well as its regional allies are on the rise. While we continue to exclude direct military conflict in our base case scenario or significant disruption to global oil supply, these risks are non-negligible. In the unlikely scenario of a blockage of the Strait of Hormuz or military conflict, the ratings on sovereigns and banks in the Gulf Cooperation Council could come under significant pressure.

Threat of No-deal Brexit Distorting National Income Components

Source: ONS, S&P Global Ratings

Oil – Spot Prices Faded After Saudi Attack; Futures Calm

Source: Refinitiv, S&P Global Ratings. Data as of Sept. 16, 2019
Latin America | Policy Uncertainty Undermines Growth Prospects

Key Takeaways

- **Overall:** Growth prospects continue to weaken as policy uncertainty in the region's largest countries increases. We have consequently lowered our growth expectations for 2019 and 2020. Although looser U.S. monetary policy helps, external conditions remain challenging.

- **What's changed:** Investment continues to slump in the largest economies as policy uncertainty prevails. Upcoming elections in Argentina, delays in key reforms in Brazil, and lack of clarity and polemic decisions in Mexico are acting as a drag on already fragile investor confidence.

- **Risks and imbalances:** Domestic political challenges continue intensifying and are the main drag on investor confidence and economic growth in the region. External conditions all remain difficult given U.S.-China trade tensions and friction in the Middle East.

- **Financing conditions:** U.S. monetary easing has improved regional financing conditions by enabling policy rate cuts. Not all have benefitted; appetite for lower-rated issuers remains limited.

- **Macroeconomic conditions:** We have lowered our 2019 and 2020 growth expectations for major regional economies. This is due to ongoing weakness in domestic demand, adverse domestic political dynamics, and volatile external conditions.

- **Sector themes:** Weaker growth is likely to dent corporations’ profits and bank’s asset quality.
Latin America | Policy Uncertainty Prevails

1. Regional Political Challenges are the main drag for domestic investor’s confidence

2. Increasing trade tensions undermine investment and global growth expectations

3. Lower interest rates in advanced economies provided some room for monetary easing

4. Commodity prices remain volatile, lower prices could hurt growth prospects

Key Takeaways

- **Overall**: As U.S.-China trade tensions fuel fears of a recession, American consumers have so far propped up the world’s biggest economy. Also, U.S. financing conditions have generally improved over the course of the year.

- **What's changed**: The chance that the U.S. will slip into recession is increasing. Of the 10 leading indicators of near-term U.S. GDP growth we look at, three are now negative.

- **Risks and imbalances**: Trade and geopolitical tensions are leading to more frequent and intense bouts of market volatility.

- **Financing conditions**: Borrowing conditions remain broadly supportive, but there has been a divergence between conditions for investment- and speculative-grade borrowers.

- **Macroeconomic conditions**: While the U.S. expansion is now the longest in history, the economy is showing signs of slowing. Our assessment puts the risk of a recession starting in the next 12 months at 30%-35%—more than twice what it was a year ago.

- **Sector themes**: Stalemate in trade negotiations has hurt business confidence, as evidenced by slumping capital expenditure growth and a contraction in manufacturing. Meanwhile, declining borrowing costs are pressuring lenders’ net interest margins and weighing on profitability.
U.S. & China Trade Dispute

2018

Jan. 22
U.S. imposes tariffs on washing machines and solar cells imports. Concerns on Chinese dominance in the global supply chain.

Feb. 1
Trump signs tariffs on imported steel and aluminum from all nations, including China.

Feb. 22
U.S. proposes tariffs in response to China's "tech transfer requirements" related to technology transfer, IP, and innovation.

Apr. 2
China says it will start buying tariffs on US$3.7 billion of U.S. imports, including high tech, fruits, wine, and pork. Early April 2018.

Apr. 4
China will levy 25% tariffs on imports of 106 U.S. products including soybeans, automobiles, chemicals, and aircraft.

Apr. 3
U.S. releases a list of high-tech industrial products as targets for proposed tariffs on US$50 billion worth of imports.

May 29
U.S. announces that it's moving ahead with tariffs on US$50 billion of imports and a plan to curb investment in sensitive technology.

Jun. 16
China announces 25% tariffs on US$50 billion of U.S. exports to China, including a lot of agricultural and food products.

Aug. 8
U.S. releases a finalized list of US$16 billion worth of Chinese goods that will be hit with tariffs. The U.S. charges will take effect on Aug. 23, 2018.

Aug. 23
China imposes 25% tariff on imported U.S. products valued at US$15 billion, will take effect on Aug. 23, 2018, including vehicles such as large passenger cars and motorcycles.

Aug. 29
U.S. raises tariffs on US$200 billion worth of Chinese imported goods to 25% from 10%. U.S. may impose 25% tariffs on another US$326 billion.

Sept. 24
China implements tariffs on US$16 billion worth of U.S. goods.

Oct. 5
U.S. reportedly prepared to announce tariffs on remaining Chinese products, i.e. US$267 billion.

2019

Feb. 1
U.S. imposes March 1, 2019, tariff hike.

Dec. 1
U.S. and China agree to a 90-day "pause" in escalating tariffs.

Aug. 1

Aug. 13
U.S. announces it will defer 10% tariffs on half of US$160 billion Chinese imports to Dec. 15, 2019.

Aug. 23
China announces plan to raise additional tariffs of 5% or 10% on US$75 billion worth of U.S. imports, and tariffs to 25% on U.S. exports. U.S. retaliation by announcing additional tariff of 5% on all Chinese imports.

Source: S&P Global Ratings
### Quarterly Changes

#### Structured Credit

<table>
<thead>
<tr>
<th>Negative</th>
<th>Stable to Negative</th>
<th>Stable</th>
<th>Stable to Positive</th>
<th>Positive</th>
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</thead>
<tbody>
<tr>
<td>Tobacco</td>
<td>Timeshares; Small business; Transportation</td>
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<td>CLO</td>
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#### North America Corporate Sector Trends – U.S.

<table>
<thead>
<tr>
<th>Negative</th>
<th>Stable to Negative</th>
<th>Stable</th>
<th>Stable to Positive</th>
<th>Positive</th>
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</thead>
<tbody>
<tr>
<td>Healthcare services; Retail; Pharmaceutical; Consumer Durables</td>
<td>Telecom; Media and entertainment; Regulated Utilities; Consumer non-durables; Forest Products</td>
<td>Aerospace and Defense; REITs; Transportation; Unregulated (merchant) power; Building materials; Oil Refineries; Homebuilders; Midstream Energy</td>
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<tr>
<td>Chemicals; Capital Goods, Technology; Oil and Gas; Leisure and Sports; Metals and Mining</td>
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<tr>
<td>Auto OEMs and Auto suppliers</td>
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Related Research

- **Credit Conditions Asia-Pacific: China Slows, Trade Tensions Blow**, Sept. 30, 2019
- **Credit Conditions EMEA: Lingering in the Lowzone**, Sept. 30, 2019
- **Credit Conditions Latin America: Policy Uncertainty Undermines Growth Prospects**, Sept. 30, 2019
- **Credit Conditions North America: Rising Recession Risk Adds To Trade, Rate Uncertainty**, Sept. 30, 2019

- **Asia Pacific Economic Quarterly: Confidence Is Shaken But Policy Is Stirred**, Oct. 1, 2019
- **Economic Research: Will Trade Be The Fumble That Ends The U.S.'s Record Run?**, Sept. 30, 2019
- **Economic Research: Low Growth And Lower Rates: The Eurozone In 2020**, Sept. 26, 2019
- **China Credit Spotlight: The Great Game And An Inescapable Slowdown**, Aug. 29, 2019
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