

## Credit Conditions Asia-Pacific:

# Tighter, Weaker, Riskier

September 27, 2018

### Key Takeaways

- **Overall:** Credit conditions in Asia-Pacific have worsened, with financing conditions tighter and macroeconomic sentiment weaker. The continuing China-U.S. trade dispute and emerging markets currency sell-down is darkening investors' mood.
- **What's changed:** The dispute between China and the U.S. over trade has escalated; the two sides are imposing tariffs on another \$260 billion of goods imports. Spillover from the emerging market crises of Latin America and Turkey is pressuring local currencies, notably the Indian rupee and Indonesian rupiah.
- **Risks and imbalances:** Trade interruption risk continues to rise. Emerging market contagion risk has returned in the form of currency sell-downs highlighting asset price volatility and liquidity pullback risks. While China's debt risk is mostly stable, the government's efforts to deleverage the system have slowed. More positively, Korean geopolitical tensions have eased.
- **Financing conditions:** As anticipated, financing conditions in emerging Asia are facing headwinds going into the fourth quarter of 2018.
- **Macroeconomic conditions:** While economic activity is still solid, leading indicators point to moderation ahead with a softening in new orders and household and business confidence.
- **Sector themes:** Not surprisingly, given macroeconomic and financing conditions, the rating trend has largely flattened out. The net rating bias has steadied at -1% in August 2018, the same as in May 2018.

*(Editor's Note: S&P Global Ratings' Credit Conditions Committees meet quarterly to review macroeconomic conditions in each of four regions (Asia-Pacific, Latin America, North America, and Europe, the Middle East, and Africa). 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 Asia-Pacific committee on Sept. 20, 2018.)*

Credit conditions in the Asia-Pacific region are marginally worse going into the fourth quarter of 2018. Financing conditions have tightened and S&P Global Ratings expects continued tightening later this year. Market volatility has sent regional currencies lower and led central banks in India and Indonesia to hike rates as a precaution. From a macroeconomic standpoint, sentiment indicators have weakened and are now trending lower. This appears to be concentrated in the orders data, and suggests that uncertainties around the China-U.S. trade war might be taking a toll.

The U.S.-China trade battle could spill over into services. China is running out of room to retaliate on goods. China's recent decision to impose tariffs on a further \$60 billion worth of U.S. goods means that, together with the \$50 billion already tariffed, about 85% of its American imports (totaling \$130 billion in 2017) could be taxed. The Trump administration has announced further tariffs on Chinese imports valued at about \$200 billion. Together with the previously-announced tariffs on \$50 billion of Chinese imports, the total amount of \$250 billion represents about 50% in value of China's 2017 exports to the U.S.

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## Credit Conditions Asia-Pacific: Tighter, Weaker, Riskier

In terms of market volatility and liquidity, investor sentiment toward emerging markets has turned since the previous quarter. The U.S. dollar has strengthened as result of strong economic performance there and global portfolio rebalancing. Furthermore, rising U.S. interest rates, along with the expectation of the Federal Reserve's tighter monetary policy have resulted in portfolio outflows from developing markets. Investors are also concerned about the potential for a full blown U.S.-China trade war.

In China, the corporate sector's deleveraging trend is pausing. This is due mainly to decelerating earnings growth rather than profligate spending or borrowing as corporate spending appetite is restrained. While authorities are committed to deleveraging for state-owned enterprises (SOEs), they are fine-tuning financial-risk reduction measures to support corporate financing. This comes amid rising stress, especially for private enterprises, from higher funding costs and lender risk aversion given slower investment spending and weakening industrial demand. However, the most vulnerable borrowers, in particular private enterprises, will continue to face higher refinancing and default risk. We estimate debt leverage will rise slightly in 2018.

Table 1

### Top Asia-Pacific Risks

#### Trade and investment interruption

<b>Risk level*</b>	Very low	Moderate	Elevated	High	Very high	<b>Risk trend**</b>	Improving	Unchanged	Worsening
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The U.S.-China trade battle could spill over into services. China is running out of room to retaliate on goods. China's imports from the U.S. totaled \$130 billion in 2017 while U.S. imports from China were about \$505 billion. China has put tariffs on \$110 billion of imports; U.S. on \$250 billion. China cannot quantitatively match the Trump administration threat to increase tariffs on further Chinese imports valued at about \$200 billion.

#### Asset price volatility and liquidity pullback

<b>Risk level*</b>	Very low	Moderate	Elevated	High	Very high	<b>Risk trend**</b>	Improving	Unchanged	Worsening
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The possibility of emerging markets contagion has heightened. Expectation of rising U.S. interest rates has led to portfolio outflows from the region. Spillover from the Latin America and Turkey crises is pressing down on local currencies, notably the Indian rupee and Indonesian rupiah. Equity market values look generous, and real property prices may soften. The risk trend may transit to worsening in coming quarters.

#### China debt overhang

<b>Risk level*</b>	Very low	Moderate	Elevated	High	Very high	<b>Risk trend**</b>	Improving	Unchanged	Worsening
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In China, the corporate sector's deleveraging trend is pausing. This is due mainly to decelerating earnings growth rather than profligate spending or borrowing as corporate spending appetite is restrained. While authorities are committed to deleveraging for state-owned enterprises (SOEs), they are fine-tuning financial-risk reduction measures to support corporate financing.

#### Geopolitical tensions

<b>Risk level*</b>	Very low	Moderate	Elevated	High	Very high	<b>Risk trend**</b>	Improving	Unchanged	Worsening
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U.S.-North Korea negotiations over denuclearization of the peninsula are continuing. Other disagreements such as China's territorial claims over parts of the South China Sea remain. This risk is somewhat indirect in that it is the market reaction (or overreaction) to an event that could undermine credit conditions.

Sources: S&P Global Ratings.

\* **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

# Regional Credit Conditions

## Somewhat Worse

### What's changed?

Credit conditions are somewhat worse, with financing conditions tighter and macroeconomic sentiment weaker. The improving rating trend has largely flattened out. The net rating bias was -1% in August 2018, the same level as in May 2018.

The rating trend has largely flattened.

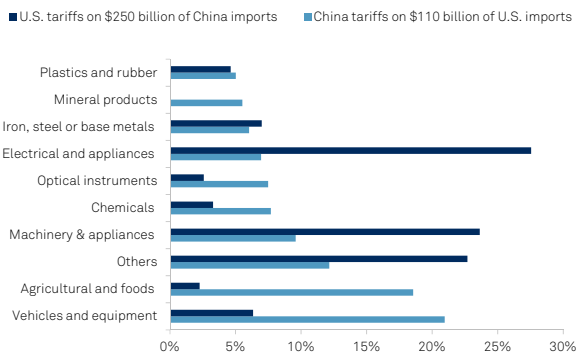
### Assessment of key risks

We regard Asia-Pacific's top risks as trade interruption; asset price volatility and liquidity pullback; the China debt overhang; and geopolitical tensions (see table 1). These regional vulnerabilities substantially overlap with our top global risks of trade and investment interruption; asset-price volatility and liquidity reversal; and the U.S. credit cycle moving closer to a turning point as leverage expands.

Chart 1

#### China -U.S. Trade Dispute Escalates

China has put tariffs on \$110 billion of imports; U.S. on \$250 billion



Source: China, MOC, United States Trade Representative Office, Dataweb of USITC, S&P Global Ratings

Chart 2

#### Indian, Indonesian Currencies Under Pressure

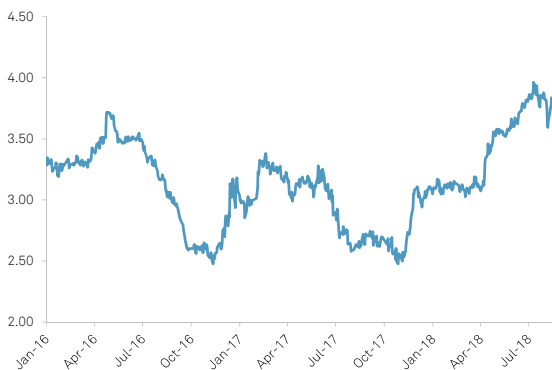


Source: Bloomberg, S&P Global Ratings.

Chart 3

#### China Credit Spreads Widen

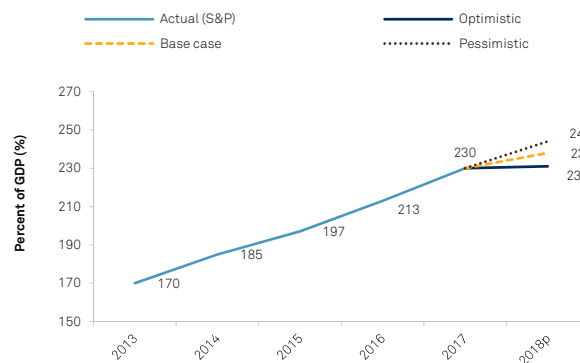
Yield gap between 5-yr Chinese government bonds and medium-term notes rated AA- (domestic rating)



Source: CEIC, S&P Global Ratings.

Chart 4

#### China's Credit-To-GDP Trajectory Softens



Source: S&P Global Ratings. p--projection.

Our assessment of the risk levels and trends remains unchanged from the last quarter except for removing geopolitical tensions from trade and investment interruption in recognition that geopolitical tensions in Korea have eased.

### **Trade and investment interruption (high, worsening)**

The direct economic effects of the U.S.-China tariff dispute have so far been limited. That may be about to change as the countries escalate their rhetoric--and their actions--in what could soon be a full-blown trade war (see chart 1) for goods under threat of further tariffs. And make no mistake, the conflict between the world's two biggest economies is at risk of a serious escalation, with U.S. President Donald Trump saying he's ready to extend new tariffs on all American imports from China--not just the \$250 billion currently subject to tariffs of 25%.

**U.S.-China tariff dispute is at serious risk of worsening.**

With China seemingly offering little to placate the White House--on the contrary, Chinese officials have responded with retaliatory tariffs and promises to stand their ground--it's difficult to see what the endgame is for either side. In our assessment of this last scenario, in which the U.S. steps up its protectionist measures by levying additional tariffs of 25% on all nonfuel imports from China, and China responds in kind, we calculate that the direct effects would shave roughly one-third of a percentage point off U.S. GDP growth per year on average in 2019-2021; for China, the loss to GDP would be around two-tenths of one percent per year--all told, rather moderate ripples for both. By 2021, the economy would be roughly one percentage point smaller (compared with a situation without a trade war) in the U.S. and six-tenths of a percentage point smaller in China.

However, this wouldn't likely be the whole story. Indeed, financial markets, which are forward looking, have at times been rattled by the trade rhetoric and actions. And earlier this year, in March, a number of Asian and European steel and aluminum manufacturers and exporters saw their share prices fall in anticipation of U.S. tariffs on steel and aluminum, and amid fears of a trade war.

Looking beyond China, the transmission to Asia-Pacific more broadly would occur on two fronts. First, there are supply-chain effects, because several trade-oriented and open Asian economies are integrated into the global supply chain for goods affected by the trade war. In particular, South Korea, Japan, and Taiwan are key trading partners for China and significant members of the regional goods supply chain, while China is now the biggest trading partner for most of Asia-Pacific. Second, reduced demand from the U.S. and China because of lower growth in these two large economies would weigh on Asia-Pacific economies.

### **Asset price volatility and liquidity pullback (high, unchanged)**

The increase in market volatility in 2018 in global asset prices underlines the significant risk of sharp corrections. This is against the backdrop of the multi-year hunt for yield and rising risk allocation in a prolonged low interest-rate environment. While a liquidity withdrawal is inevitable after the near decade-long era of easy money, the duration of such an event is hard to identify. The trigger could well be the current turn in investor sentiment against emerging markets. The turn has sent regional currencies, such as the Indian rupee and Indonesian rupiah (see chart 2), lower, leading their central banks to hike rates as a precaution. Consequently, emerging market contagion risk has heightened.

The U.S. dollar's strengthening is the result of strong economic performance there and global portfolio rebalancing. Furthermore, rising U.S. interest rates, along with the expectation of the Federal Reserve's tighter monetary policy have resulted in portfolio outflows from developing markets. Not surprisingly, financing conditions in Asia-Pacific have tightened (see chart 3) and we expect it to continue tightening for the rest of this year.

### **China debt overhang (elevated, unchanged)**

Corporate China's deleveraging trend is about to pause (see chart 4). This is due mainly to decelerating earnings growth rather than profligate spending or borrowing. We believe that underlying corporate spending appetite remains restrained, and that Chinese authorities are committed to deleveraging for state owned enterprises (SOEs). That said, authorities are fine-

tuning their financial-risk reduction measures to support corporate financing. This comes amid rising stress, especially for private enterprises, due to higher funding costs and increased risk aversion by lenders amid slower investment spending and weakening industrial demand. We believe such efforts could take pressure off some companies facing difficulties in refinancing their debt maturities, especially SOEs that rely on new borrowing to pay off old debt. However, in our view, the most vulnerable borrowers, in particular private enterprises, will continue to face higher refinancing and default risk. We estimate debt leverage will rise slightly in 2018 for our rated Greater Chinese portfolio, breaking from the deleveraging trend in 2016 and 2017.

Overall, we have a modest negative net bias in the China rated portfolio, due to deteriorating liquidity, mostly at the weaker end of the rating spectrum. This holds especially for companies in the capital goods, metals, and mining sectors, and local government financing vehicles. We expect liquidity conditions will ease in the second half of 2018 to selectively boost economic activity and relieve financial stress. While decelerating investment spending is a necessary component of deleveraging, too sharp a slowdown can knock confidence and earnings momentum.

Despite China's strong headline 6.8% GDP growth in the first half of 2018, momentum is moderating for fixed asset investment, consumption (i.e., retail sales), and exports. All these are pointing to slower industrial demand, potentially knocking commodity prices, which contributed to the strong profit recovery of upstream industry sectors in the past two years.

#### **Geopolitical tensions (elevated, improving)**

U.S.-North Korea negotiations over denuclearization of the peninsula are continuing. Other disagreements, such as China's territorial claims over parts of the South China Sea, remain. This risk is somewhat indirect in that it is the market reaction (or overreaction) to an event that could undermine credit conditions.

**We estimate debt leverage will rise slightly in 2018 for our rated Greater Chinese portfolio.**

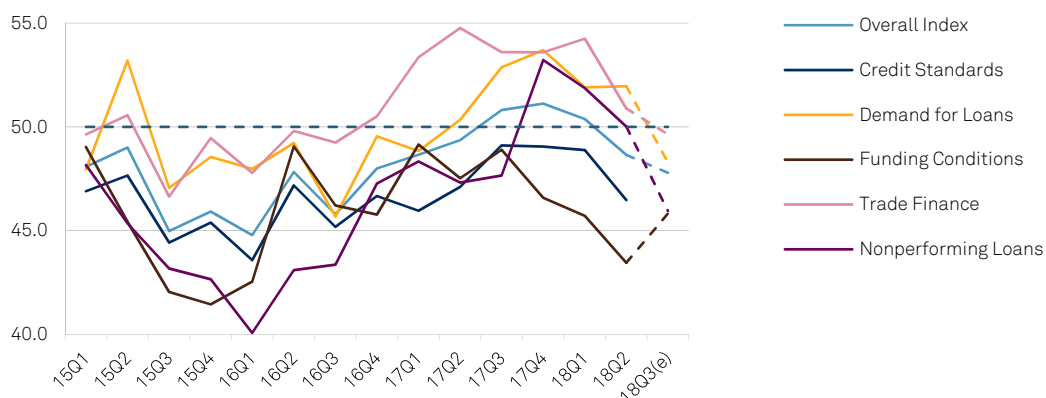
# Financing Conditions

## Tighter going into Q4

**Tighter conditions.** Financing conditions in emerging markets have tightened since the beginning of the year, with the Institute of International Finance (IIF) posting an index value of 48.6 at the end of the second quarter (from 50.4 the previous quarter) and expectations for continued tightening later this year (see chart 5). The indexes, whose values above 50 imply expansive conditions, are projected to tighten in nearly every emerging market region across the globe with the exception of the Middle East and North Africa. For Emerging Asia specifically, financing conditions are expected to deteriorate later this year though its index value teeters at 51, the edge of expansive territory.

Chart 5

### IIF Emerging Markets Bank Lending Conditions Indices



\*Dashed line denotes expectation in the next 3 months. Values below 50 indicate a tightening in bank lending conditions and values above 50 indicate easing. For NPLs, values below 50 indicate a rise in NPLs and vice-versa. The 2018 Q2 survey covering 94 EM banks was conducted during July 2018. Data source: Institute of International Finance, S&P Global.

**2018 issuance.** As of Aug. 27, 2018, a total of \$827 billion new bond issues came to market in Asia—slightly less than that of last year's \$859 billion. Thus far in 2018, over 63% of new issuance hails from Greater China, followed by Japan with 13% and Australia with 8%. Corporate bond issuance in China has grown quickly in recent years, despite government actions aimed at deterring growing debt levels. We expect global bond issuance in 2018 to decline by roughly 4.2% from the 2017 total across corporate (financial and nonfinancial), structured finance, and public finance asset classes; to \$6 trillion. Our base-case assumptions now factor in heightened market volatility, which arrived sooner in the year than we initially expected and may tick up further, depending on the extent of ongoing global trade disputes and their impact on investment and market sentiment.

**China as driver.** Chinese authorities have been engaged in an aggressive effort to deleverage corporations since 2016, yet in the year to date, the region's nonfinancial bond issuance is up 50%. Despite continued efforts to moderate corporate borrowing, China remains committed to opening domestic financial markets to international investors. This will almost certainly provide a new source of demand as the government pulls back. Maturing bonds in China over the next 18 months total \$200 billion, up from \$180 billion in the 18 months ended June 2018. Although some of this total has likely been prepaid, the large increase has been supporting issuance in the country thus far. Chinese issuance accounted for over half of all issuance outside of the U.S. and Europe in the past five years.

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**We expect financing conditions for emerging Asian economies to deteriorate later this year.**

# Macroeconomic Outlook

## Uncertainties taking a toll

(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.)

**Weakening sentiment.** Economic activity is steady after the region entered the third quarter with broad based momentum following strong growth in the second quarter (see chart 6). Most economies are recording steady growth and activity numbers, however leading indicators point to some moderation ahead with a softening in new orders and household and business confidence.

**China activity slowing.** Activity in China is still slowing moderately, largely reflecting past tightening in policy. Infrastructure investment, a key driver of growth over 2016-17, continues to slow as the authorities rein in off-balance sheet financing activities by local governments. Consumption growth remains robust. Financial conditions have eased recently reflecting lower market interest rates and smoother credit flows. This is consistent with recent signals that the government is slowing the pace of deleveraging. This should stabilize growth in the near term.

**Recent growth buoyant.** India recorded strong growth during the second quarter on the back of an improvement in domestic demand and inflation remains controlled. Australia also recorded above-trend growth driven by domestic demand and buoyant exports. Japan saw a substantial upward revision to its second quarter growth numbers indicating robust demand as household spending and wage growth remained steady.

**Outlook.** Our baseline economic outlook remains steady. We have slight upward growth revisions for Japan and Australia following their strong numbers in the second quarter. We expect domestic demand driven growth in ASEAN to continue and trade growth has slowed but not been a drag on growth so far. We continue to expect steady growth among the open trade-oriented economies-- while trade growth is slowing, it still remains fairly strong.

**Risks.** Risks have tilted to the downside on two main fronts. First, trade tensions between the U.S. and China have steadily increased and show no signs of abating. Instead, there is heightened risk of an extended trade confrontation with elevated tariffs that could have a significant impact on global trade, supply chains, and economic confidence. Second, capital outflow pressures are persisting due to better growth in the U.S., tighter U.S. monetary policy, and contagion effects from Argentina and Turkey. Most economies in the region are less vulnerable to outflows now compared with 2013, when the last round of capital outflows happened.

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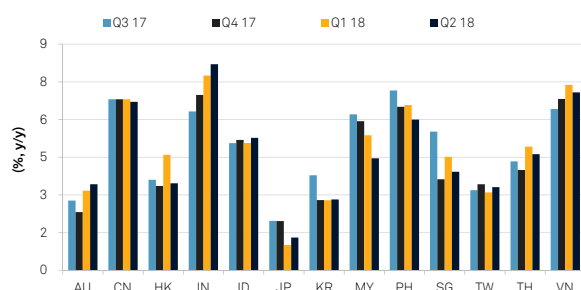
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**Our growth outlook for the region remains broadly unchanged, but downside risks are building.**

Chart 6

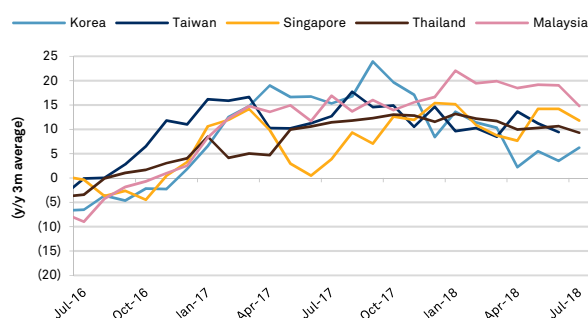
### GDP Growth Remained Buoyant In Q2



Source: CEIC.

Chart 7

### Export Growth Strong But Slowing



Source: CEIC.

## Sector Trends

### Rating bias improvement pauses

The previously improving rating trend has flattened overall for the Asia-Pacific region (see chart 8 and table 2 in Appendix 1) as economic sentiment slightly weakens amid the China-U.S. trade dispute and financing conditions slightly tighten. The net rating outlook bias remained at -1% in August 2018, the same as -1% in May 2018, after improving over the 18 months since the fourth quarter of 2016. The primary source of regional risks is external, although it's uncertain whether China is actually slowing faster than what investors anticipated. Trade interruption risk is still rising given that the U.S. and China have imposed, and are threatening to impose, import tariffs on each other. Meanwhile, upward pressure on interest rates and spreads is occurring, and investor sentiment points to a potential turn in the U.S. credit cycle in late 2019.

The previously improving rating trend has flattened overall for the Asia-Pacific region.

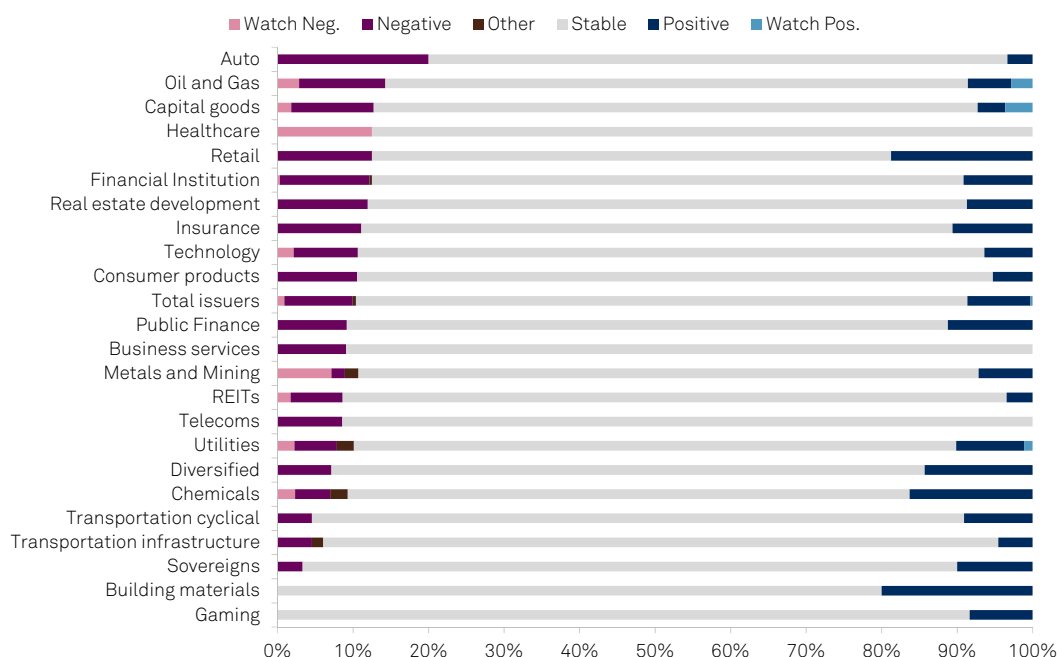
(We calculate the net rating bias by deducting the percentage of negative outlooks and CreditWatch listings against the percentage of positive outlooks and CreditWatch listings. A minus figure indicates that the percentage of negative outlooks and CreditWatch listings exceeds the percentage of positive outlooks and CreditWatch listings; and a positive figure, vice versa.)

In summary, the main rating developments in Asia-Pacific are:

- The net rating bias for nonfinancial corporates is -2% in August 2018. This is a marginal worsening over the 0% (i.e., neutral) in May 2018. While economic growth is generally supportive of credit profiles, competitive pressure remains in some sectors.
- For financial institutions, the net rating bias improved to around negative 3% as of August 2018 from negative 6% in May 2018. This improvement was partly driven by new issuers coming into the pool.
- For insurance entities, the rating bias improved to negative 1% in August 2018 from negative 3% in May 2018.
- The positive net rating biases for both sovereign and international public finance are little changed at 7% and 2% respectively for August 2018 (7% and 3% in May 2018).

Chart 8

#### Net Outlook Bias Distribution Of Asia-Pacific Issuers By Sector, August 2018



Source: S&P Global Ratings. REITs – real estate investment trusts.



# Non-financial Corporates

## The good times may be passing

- Rising trade tensions and other risks indicate a worsening outlook despite momentum from economic growth continuing to be somewhat supportive.
- Auto sector continues to have the highest negative bias because of competitive and cost pressures. Some real estate developers could be vulnerable to a liquidity crunch scenario in view of 2019-2020 maturity bunching.
- The weakening likelihood of Chinese local governments to provide extraordinary support to their financing arms led us to lower ratings on seven local government financing vehicles.

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### What's changed?

**Rating bias trend reversal.** As economic sentiment weakens amid the China-U.S. trade dispute and financing conditions tighten, the improving rating trend has reversed slightly. Our net negative rating bias weakened to -2% in August 2018, down from a neutral 0% in May 2018.

**More competition and regulation for some.** Automakers and suppliers are facing intensifying competitive pressure while telecommunications players in a few Southeast Asian countries, India, Australia, and Taiwan are dealing with mounting competition and/or regulatory change.

**Weakening LGFV support.** The role and link of Chinese local government financing vehicles (LGFVs) is transitioning as the central government seeks to enforce a greater separation between local governments and their financing vehicles. The reforms are part of efforts to reduce financial risks and deleverage the state-owned corporate sector, and include a crackdown on off-budget borrowing by local governments.

### Key assumptions

**Steady GDP growth.** Our base case is for the momentum from global economic growth to support revenue and earnings growth over the next few quarters. Consequently, most sectors should see steady credit profiles near term.

**Capex.** Similarly, we expect the momentum of capex spending to continue for the next few quarters.

### Key risks

**Trade.** With China remaining a growth engine for the region, trade interruption caused by the U.S.-China tariff war is impacting business confidence and may depress future investment.

**Financing.** Financing conditions are tightening, whether by domestic lenders or offshore investors, which could trigger a liquidity pullback from more leveraged borrowers. Currency volatility also remains an ongoing risk factor with emerging market capital flows exposed to changing risk sentiment.

**China.** Credit growth in China had been slowing but looks to be picking up speed again. Such growth is a two-edged sword--it supports GDP growth but if the quality is poor, it will make the task of deleveraging much harder.

**Regulation.** For a few sectors, such as gaming, telecommunications, transport and utilities, government policy and regulation remain ongoing risks.

### What to look for over the next quarter

**Business and investor confidence.** While currently of low impact, there is the risk of adverse business conditions triggered by the China-U.S. trade war. Another complication is investor sentiment toward the risk-return equation, which could trigger capital outflows--particularly in emerging markets--with associated adverse currency and asset price impacts.

# Financial Institutions

## Risks are on the downside amid stable outlook

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- With the notable exception of India--where nonperforming loans are high--we believe we are at or near the peak of the credit cycle for banks in many jurisdictions.
- High private sector debt in many Asia-Pacific jurisdictions is a key risk factor.
- Higher U.S. interest rates and depreciating and volatile domestic currencies pose threats.

### What's changed?

**Rating outlook remains relatively stable.** Relatively few rating changes occurred over the past quarter. We expect this trend to continue over the short term. Across the region, about 78% of rating outlooks are stable, with about 13% negative and 9% positive.

**Negative rating bias persists.** Principally driving negative rating outlooks are two key factors: (i) Australian systemically-important banks and their subsidiaries are on negative outlook because of a potential lessening of Australian government support; (ii) Risks of deteriorating creditworthiness in the finance company and broker segments. We note also that Japanese banks remain under pressure because of weak profitability in the competitive, low interest rate environment.

**Low-probability, high-impact negative scenario.** While our base-case outlook is for relative ratings stability, we see limited upside for ratings on Asia-Pacific financial institutions but some potential key downside risks. A potential escalation of risk factors could cause a negative step-change. High debt levels across the region, high asset prices, skittish bond markets, and, more recently, significant currency volatility, could set the stage for a deterioration in credit quality.

### Key assumptions

**Macroeconomic conditions stable.** While our outlook for macroeconomic conditions is relatively stable, we are cautious toward a potential deterioration in credit conditions precipitated by higher U.S. interest rates and more-volatile domestic currencies.

**Governments remain supportive.** We currently envisage no significant weakening of government support for systemically-important banks in Asia-Pacific, except for Australia.

### Key risks

**High debt, increasing interest rates, and greater currency volatility.** High private-sector debt (including in China, Hong Kong, Australia, Korea, Singapore, Malaysia, and Thailand) is a key risk factor amid tightening U.S. interest rates and more volatile, depreciating domestic currencies. High asset prices, in particular property prices in some banking sectors, is a key risk. A sharp correction in asset prices, particularly if associated with a pullback in market liquidity and negative secondary impacts on banks, will likely lead to negative ratings momentum.

### What to look for over the next quarter

**Asset quality, capital and earnings relatively stable in the short term.** Absent a negative step change in credit conditions, nonperforming loans should remain relatively low in many jurisdictions, including Taiwan, Australia, New Zealand, Singapore, Hong Kong, and Japan. By contrast, the asset quality outlook for Indian banks remains weak, by global and regional standards. The earnings and capital outlook for banks in many Asia-Pacific jurisdictions remains supportive of current ratings--our base case is for no significant change, in the short term.

## Insurance

### Investment market volatility to dampen credit strength

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- The negative rating bias for the region's insurers is mainly due to the ratings on their parent groups.
- Continuing economic growth prospects support stabilizing rating trends.
- Insurers' sensitivity toward investment market volatility increases amid rising exposure to risky assets.

#### What's changed?

**Continuing economic growth prospects.** Supportive economic growth will facilitate a stable business environment for Asia-Pacific insurers. While escalating China-U.S. trade dispute gives rise to uncertainty, we anticipate muted second-degree impact (i.e., lower demand for marine and credit insurance due to slower trade activity) given still-strong domestic demand for insurance cover.

**Increasing investment market volatility.** While the rising, albeit still low, interest rate environment will broadly benefit insurers for their reinvestments, the revaluation of existing assets might result in some volatility of insurers' balance sheets. The recent trade tension between China and U.S. may weigh on emerging market currencies and introduce more volatility for insurers with significant unhedged currency exposures.

#### Key assumptions

**Earnings pressure to stay.** The availability of underwriting capacity and a catastrophe-benign environment continue to keep premium rates low for property and casualty insurers and reinsurers. Heightening acquisition expenses and compliance costs, amid escalating domestic competition, will dilute profitability.

**Asset growth outpacing capital.** Continued strong growth in asset bases at life insurers adds to rising credit risk exposure. At the same time, the low interest rate environment has prompted increasing allocation toward higher-yielding and less-liquid investments. This is especially so in China, given the higher uptake in infrastructure and real estate investment.

#### Key risks

**Volatile investment markets.** Insurers' pursuit of more aggressive investments to enhance profits, amid intensifying market competition across the region, expose them to greater investment volatility. Unhedged offshore investments expose insurers to potential foreign exchange fluctuations, introducing new pressure on insurer capitalization.

**Rising interest rates to hike funding costs.** While rising U.S. interest rates improve insurers' reinvestment options, the higher funding costs may derail their offshore debt issuance plans. Instead, insurers may focus on raising debt capital domestically.

**Potential catastrophe risks.** Changing weather patterns and increasing urbanization will increase insurers' exposure to natural and manmade catastrophe events. These risks continue to weigh on insurers operating in emerging markets with less claims experience.

## Public Finance

### Recent policy shift won't derail Chinese LRG sector's de-risking trend

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- The recent policy shift could resuscitate credit growth in China's local government sector and public investment vehicles over the next six to 12 months.
- We expect this is unlikely to alter the de-risking trend of the sector in the medium to long term, given that a strong risk appetite is unlikely to return amid concerns over a weakening Chinese economy.

#### What's changed?

**China's public sector allowed breathing space.** China's deleveraging policy theme took a pause in June, when the central government eased its monetary policy and pushed for more fiscal expansion to stabilize the economy. This change is triggered by continued weak readings on credit growth, a huge slump in infrastructure investment growth, and an increasingly unfavorable external environment.

By emphasizing “stabilizing deleverage” rather than “deleverage,” Chinese policymakers are now encouraging financial institutions to continue to support local government financing vehicles' (LGFVs) financing channel to ensure existing infrastructure investment can be implemented without disruption.

#### Key assumptions

**Chinese LRGs' bond issuances set to accelerate in H2 2018.** Chinese authorities have directed local and regional governments (LRGs) to speed up their bond issuances to alleviate the funding shortage for infrastructure investments. Although LRGs' bond issuances will still be capped by the quota set by the central government, the pace of issuances in the second half of the year is set to accelerate to resuscitate public investment. However, we consider that the level won't threaten the sector's overall de-risking trend.

#### Key risks

**Policy reversal.** Even though we don't expect current easing measures to completely derail the government's deleveraging policy agenda, current accommodative measures do create uncertainty around the Chinese public sector's credit growth trajectory. If these accommodative measures persist, it may herald a return of risk appetite at LGFVs.

#### What to look for over the next quarter

**Policy shift to resuscitate credit growth for Chinese LRGs.** For Asia-Pacific's public finance entities, China's macro policy setting is in the spotlight. The country's policy setting is becoming more accommodative amid an expansionary fiscal policy. Authorities are softening their deleveraging tone that hit public financing and infrastructure investment hard in H1 2018. The impact occurred amid concerns around a weakening Chinese economy. Recent easing measures avoid sectorwide financial stress for LGFVs that could pose great contingent risks for the local government sector.

## Sovereign

### Steady economies support credit quality

- Geopolitical tensions, increasingly hostile trade policies and more recently, the emerging market rout pose tail risks for sovereigns in Asia-Pacific.
- We believe steady economic conditions in major developed economies and growing domestic demand will support sovereign ratings across Asia-Pacific.

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#### What's changed?

**Trade risks materializing.** Moving beyond rhetoric, the U.S. has imposed tariffs on imports from China and the latter has retaliated. While the initial impact is limited, further escalation could threaten growth prospects in the region and exert downward pressure on credit metrics.

**Increasing aversion to emerging markets.** Emerging market economies in Asia-Pacific have been affected by the global aversion toward emerging market assets. Capital outflows are likely to intensify as the Federal Reserve continues to hike rates, exerting further pressure on foreign exchange and threatening reserves buffers in the region.

**China adjusting deleveraging policy.** Chinese policymakers have taken a more cautious approach toward financial deleveraging. Although they have not reversed course, the pace of deleveraging may have slowed. While supportive of growth in the short term, reopening the credit taps can increase the likelihood of an abrupt economic correction in the future.

#### Key assumptions

**Impact of trade actions will be limited.** The direct impact of trade actions implemented thus far is not likely to significantly weigh on regional growth, at least for this year. Both the U.S. and China will continue to explore ways to resolve trade differences.

**Policy responses will maintain investor confidence** where sovereigns are more sensitive to global capital flows to prevent a sharp pullout of funds.

#### Key risks

**Sudden capital swings.** Abrupt international capital flow reversals remain a risk that could sharply increase financing costs, damaging confidence and short-term growth prospects in economies that are reliant on external funding. This risk has increased in light of the global emerging market rout and can be triggered by an unforeseen negative event.

**Unsteady or reversal of the deleveraging policy in China.** If negative developments, particularly on the trade front, significantly affect China's growth story, the deleveraging policy could reverse. That is likely to weaken sovereign credit support for the government due to growing risks of financial instability. If the loss in confidence spreads across the region, then other Asia-Pacific sovereigns could also be negatively affected.

#### What to look for over the next quarter

**Geopolitical tensions in Asia, and rising protectionism.** Protectionist trade policies between China and the U.S. could greatly intensify, weighing on growth prospects. Given the interconnectedness of regional economies through global supply chains, contagion effects can threaten a number of credit metrics in a number of sovereigns around the region. The trade tensions may also have weakened cooperation between the two countries with respect to geopolitical risks, especially on the Korean peninsula. There is also the risk that, as the trade dispute drags on without a clear way to resolve it, the two countries may apply geopolitical pressures elsewhere to try to get back to serious negotiations.

## Structured Finance

### Refinancing conditions likely to tighten for certain borrowers

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- Synchronized improvement in macroeconomic conditions underpins the stable performance in structured finance markets given that loss of income is a key cause of default across asset classes.
- The trade dispute with the U.S. is yet to affect employment conditions or asset performance, though its impact could present risks.
- Refinancing conditions may be tougher for certain borrower types and loan products in Australia as lending conditions tighten.

#### What's changed?

**Tightening refinancing conditions in Australia.** Tightening in lending conditions may create refinancing pressure for higher risk borrowers in Australia. Prepayment rates are slowing across Australian residential mortgage-backed securitization (RMBS) transactions, indicating a level of refinancing pressure for some borrowers. We do not expect this pressure to affect ratings. Around 60% of loans underlying Australian RMBS portfolios are owner-occupier, amortizing loans, attracting strong competition among lenders for this type of low-credit risk borrower.

**Modest LTVs provide a buffer against a softening in Australian property prices.** The weighted average loan-to-value (LTV) ratio of the Australian RMBS sector is around 60%. This provides a level of buffer to weather a moderate deterioration in property prices. Given the high seasoning of most loan portfolios, many loans have benefited from strong property price appreciation in recent years, particularly in the more populous capital cities of Sydney and Melbourne.

#### Key assumptions

**Stable employment.** Under our base case, we expect asset performance including arrears and losses to remain low given that we forecast employment conditions will remain relatively stable in the region's major securitization markets. This will help to offset the softening in property markets in Australia and rising interest rates more broadly. For China, the trade dispute with the U.S. is yet to affect employment conditions or asset performance, though its impact could present risks.

#### Key risks

**The trade dispute between China and the U.S.** If a comprehensive conflict unfolds, a potential ripple effect could occur on China's economic growth. And currently stable employment may change, leading to deterioration in loan performance. For now, we believe this is a tail risk. The highly diversified obligor's profile and the quick accumulation of credit enhancement levels with fast pay-down of loans may provide support to deal performance even if such adverse scenarios happen, in our viewpoint.

**Transition of interest-only loans to amortizing loans.** Around 50% of interest-only loans in Australian RMBS transactions will reach their interest-only maturity dates by 2019. Interest-only loans underwritten prior to 2015--when lending standards for interest-only loans were less stringent--may be more exposed to repayment shock.

#### What to look for over the next quarter

**Increasing appetite for higher risk loans.** The retreat of several banks from nonresident and self-managed super fund loans in Australia is opening up opportunities for nonbank lenders to fill the void.

## Related Research

- Credit Conditions EMEA: Looking Over The Edge On Trade And Brexit, Sept. 27, 2018
- Credit Conditions Latin America: Weakening Investor Sentiment Will Test Latin America's Decision Makers, Sept. 27, 2018
- Credit Conditions North America: U.S.-China Trade Tensions Threaten Favorable Conditions, Sept. 27, 2018
- Sector Roundup Asia-Pacific: Rising Risks Cool Gain In Rating Bias, Sept. 25 2018
- Economic Research: Global Trade At A Crossroads: It's Hard To See Any Winners In A U.S.-China Trade War, Sept. 5, 2018
- Slower Earnings Growth Drags On Deleveraging For Corporate China, Aug. 27, 2018
- China's Long Credit Cycle Has Ended And Deleveraging Has Begun: Can It Be Sustained?, August 2018

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## Appendix 1: Ratings trends

Table 2

### Net Rating Bias Of Asia-Pacific Issuers By Sector, August 2018

	Aug. 2017	Oct. 2017	Feb. 2018	May 2018	Aug. 2018	No. of entities	Notional average rating
Auto OEM and suppliers	4%	-10%	-14%	-17%	-17%	30	BBB
Building materials	-8%	17%	23%	13%	23%	15	BBB-
Business services	0%	0%	0%	0%	-9%	11	BB
Capital goods	-15%	-14%	-2%	-2%	-5%	55	BBB-
Chemicals	0%	18%	19%	23%	9%	43	BBB+
Consumer products	0%	0%	0%	-3%	-5%	38	BBB-
Diversified	-8%	0%	8%	8%	7%	14	BBB+
Gaming, media and entertainment	-17%	-15%	-4%	0%	8%	24	BB
Healthcare	-33%	-38%	-38%	-14%	-13%	8	BB+
Investment Company	-10%	0%	0%	0%	0%	9	BBB+
Metals and mining	-9%	-4%	2%	2%	-2%	56	BB
Oil and gas	-19%	-5%	0%	0%	-6%	35	BBB
Project finance	0%	0%	0%	0%	0%	9	A-
Real estate development	-21%	-14%	-11%	-5%	-3%	92	BB-
Real estate investment trusts	-9%	-5%	-2%	-2%	-5%	58	A-
Retail	-10%	-11%	-5%	0%	6%	16	BBB-
Technology	-7%	-2%	0%	-2%	-4%	47	BBB-
Telecommunications	-12%	-9%	-9%	-8%	-9%	35	BBB
Transportation cyclical	-10%	-5%	-5%	5%	5%	22	BBB-
Transportation infrastructure	-3%	2%	0%	0%	0%	66	BBB+
Utilities	-2%	5%	2%	5%	2%	89	BBB+
<b>Total corporates</b>	<b>-9%</b>	<b>-4%</b>	<b>-1%</b>	<b>0%</b>	<b>-2%</b>	<b>772</b>	<b>BBB-</b>
Financial Institutions	-18%	-13%	-10%	-6%	-3%	328	BBB+
Insurance	-10%	-7%	-8%	-3%	-1%	198	A
Public Finance	-3%	-3%	-4%	3%	2%	98	A
Sovereign	-19%	-11%	-8%	7%	7%	30	BBB
<b>Total issuers</b>	<b>-11%</b>	<b>-7%</b>	<b>-5%</b>	<b>-1%</b>	<b>-1%</b>	<b>1,426</b>	<b>BBB+</b>

Light blue colored cells indicate improvement from prior period, navy blue deterioration.



## Appendix 2: Economic data and forecast summaries

For a fuller discussion please see *Economic Research: APAC Economic Snapshots*, published September, 2018.

Table 3

### Australia – S&P Global Ratings Economic Outlook

	2017	2018f	2019f	2020f	2021f
Real GDP %	2.2	2.9	2.9	2.9	2.8
CPI Inflation %	1.9	2.2	2.4	2.3	2.1
Unemployment Rate %	5.6	5.4	5.4	5.3	5.2
Policy Rate %	1.5	1.5	1.66	1.97	2.22
Policy Rate % (EOP)	1.5	1.5	1.75	2.00	2.25
Exchange Rate (A\$ per US\$)	0.77	0.77	0.74	0.76	
Exchange Rate (A\$ per US\$) EOP	0.77	0.75	0.75	0.76	

Source: Oxford Economics; f: S&P Global Ratings forecast; End of Period - Q4 values.

Table 4

### China – S&P Global Ratings Economic Outlook

	2017	2018f	2019f	2020f	2021f
Real GDP %	6.9	6.5	6.3	6.1	6.0
CPI Inflation %	1.5	2.4	2.3	2.3	2.2
Unemployment Rate %	3.9	3.9	3.9	4.0	4.0
Policy Rate %	4.35	4.35	4.35	4.35	4.35
Policy Rate % (EOP)	4.35	4.35	4.35	4.35	4.35
Exchange Rate (Per US\$)	6.8	6.4	6.4	6.4	
Exchange Rate (Per US\$) EOP	6.6	6.4	6.4	6.4	

Source: Oxford Economics; f: S&P Global Ratings forecast; End of Period - Q4 values.

Table 5

### Hong Kong – S&P Global Ratings Economic Outlook

	2017	2018f	2019f	2020f	2021f
Real GDP %	3.8	3.8	3.3	2.9	2.9
CPI Inflation %	1.5	2.5	2.2	2.1	2.2
Unemployment Rate %	3.1	2.9	3.0	3.0	3.1
Exchange Rate (Per US\$)	7.79	7.84	7.82	7.78	
Exchange Rate (Per US\$) EOP	7.81	7.85	7.81	7.76	

Source: Oxford Economics; f: S&P Global Ratings forecast; End of Period - Q4 values.

Table 6

**India – S&P Global Ratings Economic Outlook**

	2017	2018f	2019f	2020f	2021f
Real GDP %	6.7	7.5	7.8	7.9	8.0
CPI Inflation %	3.6	4.7	4.5	4.5	4.5
Policy Rate %	6.08	6.31	6.50	6.50	6.31
Exchange Rate (Per US\$)	64.45	66.75	67.03	68.18	
Exchange Rate (Per US\$) EOP	65.04	67.00	67.50	69.70	

Sources: Oxford Economics; f: S&P Global Ratings forecast; End of Period - Q4 values. Data for all years is for fiscal years. For instance, 2016 means April 2016-March 2017.

Table 7

**Indonesia – S&P Global Ratings Economic Outlook**

	2017	2018f	2019f	2020f	2021f
Real GDP %	5.1	5.2	5.5	5.7	5.6
CPI Inflation %	3.8	3.5	3.8	3.9	4.0
Unemployment Rate %	5.4	5.0	5.0	4.9	4.6
Policy Rate %	4.59	4.88	5.25	5.19	4.56
Policy Rate % (EOP)	4.25	5.25	5.25	5.00	4.50
Exchange Rate (Per US\$)	13,379	13,811	13,831	13,693	
Exchange Rate (Per US\$) EOP	13,534	13,886	13,789	13,624	

Sources: Oxford Economics; f: S&P Global Ratings forecast; End of Period - Q4 values.

Table 8

**Japan – S&P Global Ratings Economic Outlook**

	2017	2018f	2019f	2020f	2021f
Real GDP %	1.7	0.9	1.2	0.1	1.2
CPI Inflation %	0.5	1.2	1.2	1.9	1.6
Unemployment Rate %	2.8	2.6	2.7	2.7	2.7
Policy Rate %	(0.05)	(0.05)	(0.04)	(0.04)	(0.04)
Policy Rate % (EOP)	(0.04)	(0.04)	(0.04)	(0.04)	(0.04)
Exchange Rate (Per US\$)	112.1	109.5	110.6	111.7	
Exchange Rate (Per US\$) EOP	112.9	110.5	110.7	112.1	

Sources: Oxford Economics; f: S&P Global Ratings forecast; End of Period - Q4 values.

Table 9

**Malaysia – S&P Global Ratings Economic Outlook**

	2017	2018f	2019f	2020f	2021f
Real GDP %	5.9	5.4	5.1	4.9	4.8
CPI Inflation %	3.8	2.3	2.9	3.0	2.9
Unemployment Rate %	3.4	3.4	3.3	3.3	3.3
Policy Rate %	3.00	3.23	3.53	3.75	3.75
Policy Rate % (EOP)	3.00	3.25	3.75	3.75	3.75
Exchange Rate (Per US\$)	4.30	3.98	4.06	4.00	
Exchange Rate (Per US\$) EOP	4.16	4.06	4.05	3.96	

Source: Oxford Economics; f: S&amp;P Global Ratings forecast; End of Period - Q4 values.

Table 10

**Philippines – S&P Global Ratings Economic Outlook**

	2017	2018f	2019f	2020f	2021f
Real GDP %	6.7	6.7	6.8	6.6	6.6
CPI Inflation %	2.9	4.3	3.4	3.0	3.0
Unemployment Rate %	5.7	5.2	5.1	4.9	4.1
Policy Rate %	3.00	3.38	4.13	4.25	4.50
Policy Rate % (EOP)	3.00	3.75	4.25	4.25	4.50
Exchange Rate (Per US\$)	50.4	52.5	52.8	51.6	
Exchange Rate (Per US\$) EOP	50.9	53.1	52.7	50.6	

Source: Oxford Economics; f: S&amp;P Global Ratings forecast; End of Period - Q4 values.

Table 11

**Singapore – S&P Global Ratings Economic Outlook**

	2017	2018f	2019f	2020f	2021f
Real GDP %	3.6	3.2	3.1	2.8	2.9
CPI Inflation %	0.6	0.8	2.1	2.4	2.1
Unemployment Rate %	2.2	2.0	2.0	1.9	1.9
Exchange Rate (Per US\$)	1.4	1.3	1.3	1.3	
Exchange Rate (Per US\$) EOP	1.4	1.3	1.3	1.3	

Sources: Oxford Economics; f: S&amp;P Global Ratings forecast; End of Period - Q4 values.

Table 12

**South Korea – S&P Global Ratings Economic Outlook**

	2017	2018f	2019f	2020f	2021f
Real GDP %	3.1	2.7	2.6	2.8	2.6
CPI Inflation %	1.9	1.7	1.9	1.8	1.6
Unemployment Rate %	3.7	3.8	3.8	3.5	3.3
Policy Rate %	1.27	1.56	1.88	2.00	2.00
Policy Rate % (EOP)	1.33	1.75	2.00	2.00	2.00
Exchange Rate (Per US\$)	1,131.0	1,075.8	1,079.4	1,083.8	
Exchange Rate (Per US\$) EOP	1,107.5	1,075.7	1,081.1	1,085.4	

Source: Oxford Economics; f: S&amp;P Global Ratings forecast; End of Period - Q4 values.

Table 13

**Taiwan – S&P Global Ratings Economic Outlook**

	2017	2018f	2019f	2020f	2021f
Real GDP %	2.9	2.8	2.5	2.5	2.5
CPI Inflation %	0.6	1.5	1.3	1.4	1.2
Unemployment Rate %	3.8	3.5	3.4	3.1	3.1
Policy Rate %	1.375	1.469	1.625	1.625	1.625
Policy Rate % (EOP)	1.375	1.625	1.625	1.625	1.625
Exchange Rate (Per US\$)	30.4	29.6	29.6	29.4	
Exchange Rate (Per US\$) EOP	30.1	29.6	29.5	29.2	

Sources: Oxford Economics; f: S&amp;P Global Ratings forecast; End of Period - Q4 values.

Table 14

**Thailand – S&P Global Ratings Economic Outlook**

	2017	2018f	2019f	2020f	2021f
Real GDP %	3.9	4.1	3.8	3.8	3.8
CPI Inflation %	0.7	1.1	1.6	1.8	2.0
Unemployment Rate %	1.2	1.2	1.2	1.2	1.3
Policy Rate %	1.50	1.50	1.69	2.09	2.41
Policy Rate % (EOP)	1.50	1.50	1.88	2.25	2.50
Exchange Rate (Per US\$)	33.9	31.5	31.1	30.8	
Exchange Rate (Per US\$) EOP	32.9	31.5	30.9	30.8	

Sources: Oxford Economics; f: S&amp;P Global Ratings forecast; End of Period - Q4 values.

Table 15

**Vietnam – S&P Global Ratings Economic Outlook**

	2017	2018f	2019f	2020f	2021f
Real GDP %	6.8	6.7	6.6	6.6	6.6
CPI Inflation %	3.5	4.0	4.3	4.2	4.2

Source: S&amp;P Global Ratings.

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