S&P Global Ratings

Credit Conditions North America:

U.S.-China Trade Tensions Threaten Favorable Conditions

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Regional Credit Conditions Chair

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Contents

Key Takeaways

- **Overall:** Credit conditions in North America remain broadly favorable, with the current credit cycle continuing its historic run. But the risk that the U.S.-China tariff dispute will devolve into an all-out trade war—spurring secondary effects such as supply-chain disruption and weighing on investor sentiment—outweighs the threats posed by monetary policy normalization and the prospects for widening credit spreads for borrowers in the region.
- **What's changed:** The U.S. and China have escalated their tariff dispute, and the two sides show little sign of forging a compromise.
- **Risks and imbalances:** Beyond the possibility of a full-blown trade war with China and increased tensions with the U.S.'s other largest trade partners, we see rising corporate debt, the prospect that borrowing costs will rise faster than we forecast, and imbalances in Canada's housing market as the biggest risks to North American credit conditions.
- **Financing conditions:** Through August, nearly all indicators of financing conditions remained favorable for corporate borrowers, and we expect the default rate to decline through the first half of next year.
- **Macroeconomic conditions:** With U.S. economic momentum remaining solid, S&P Global Ratings expects above-trend GDP growth this year and next—at 2.9% and 2.3%, respectively. The strong labor market, still-bullish consumer confidence, and favorable manufacturing sentiment all bolster this view.
- **Sector themes:** While the direct effects of the U.S.-China trade dispute varies—and remain manageable for now—borrowers face some late-cycle dynamics, including the prospect of widening credit spreads and reduced liquidity.

(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 North America committee on Sept. 20, 2018.)

While credit conditions in North America remain broadly favorable—with the current credit cycle continuing its historic run—the risk that the U.S.-China tariff dispute will devolve into an all-out trade war outweighs the threats posed by monetary policy normalization and the prospects for widening credit spreads for borrowers in the region.

With the U.S. making good on its threat to impose tariffs on another $200 billion of Chinese imports—with tariffs of 10% starting Sept. 24 and rising to 25% in the New Year, unless the two countries compromise—China has again vowed to retaliate. This increases the likelihood that the White House will impose tariffs on another $250 billion-plus in goods from its largest trading partner. At that point, almost every Chinese product Americans buy would be subject to tariffs.

For China, a response of tariffs of 5%-10% on another $60 billion of U.S. goods—together with levies on the $50 billion of goods already announced—means that about 85% of the country's American imports (which totaled $130 billion last year) would be taxed. S&P Global Ratings believes this escalation will further weigh on investor sentiment and global economic growth.

Table 1

Top North-America Risks

Retaliatory tariffs threaten global trade and investment

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

Heated rhetoric, escalating trade tensions and tit-for-tat retaliatory tariffs between the U.S. and its major trading partners remain a threat to global trade and investment. The latest salvo includes new tariffs (initially 10% and rising to 25% at the start of 2019 if the two side can't come to a compromise) on an additional $200 billion in U.S. imports from China. Companies with foreign affiliates connected to integrated supply chains could feel the impact through multiple channels if tariffs sap demand for their exports and also raise import costs for the intermediate inputs they source abroad. Higher prices for imported goods will squeeze consumer purchasing power. Over time, lower trade that reduces competition could undermine productivity and potentially unwind any short-term employment gains arising from reshoring production.

The credit cycle is moving closer to a turning point as leverage expands

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

Declining average credit quality along with a pick-up in U.S. leveraged lending and speculative-grade bond issuance since 2012 could amplify credit stresses if investor risk aversion unwinds still compressed credit spreads, or reduces share prices and reduces market access to debt, or equity financing.

Credit spread normalization could destabilize access to cheap funding

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

Increased buying of U.S. fixed income assets on capital outflow pressures for select emerging markets have limited credit spread widening and an erosion of favorable financing conditions for U.S. nonfinancial corporate borrowers. Still, risk repricing, spread widening and debt-servicing pressures remain a potential threat for highly leveraged borrowers as the Fed shrinks its balance sheet and the need for monetary policy accommodation wanes.

Housing imbalances remain a threat for Canada even as credit growth slows

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

Household credit growth continued to slow in the first half of 2018 with interest rate rises from the Bank of Canada and new federal government mortgage lending guidelines curbing growth in residential mortgage borrowing. Consumer debt as a share of disposable income is increasing more slowly and slower home price appreciation suggests overheated demand conditions are easing in Toronto and Vancouver's real estate markets. Still, with elevated price-to-income multiples squeezing home affordability and households having accumulated a record C$2.2 trillion in credit market debt, housing market imbalances remain a key vulnerability for Canada's economy. The NAFTA renegotiation and potential contagion from global trade tensions are similarly a risk for Canada's trade-oriented growth prospects.

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

Global trade-data specialist Panjiva, part of S&P Global Market Intelligence, believes that the effect of the new tariffs on American consumers and companies will depend in part on whether there are alternative supplies to China. Among consumer products, the most exposed are home appliances (59% of imports come from China). For corporations, it's components for PCs and related devices (70%).

From a credit conditions perspective, we are concerned about the indirect effects on investor and consumer confidence—as well as the risk that China will retaliate with non-tariff actions, given the Chinese government's precedent of discouraging of citizens to buy foreign goods, as happened when sales of Japanese cars tumbled in late-2012 when the countries engaged in a territorial dispute, and again last year during the country's unofficial boycott of South Korean consumer goods.

We estimate that an escalation to 25% tariffs on all nonfuel goods between the two largest economies, with a shock to confidence added in, could shave a cumulative 1.2 percentage points off U.S. GDP in 2019-2021.

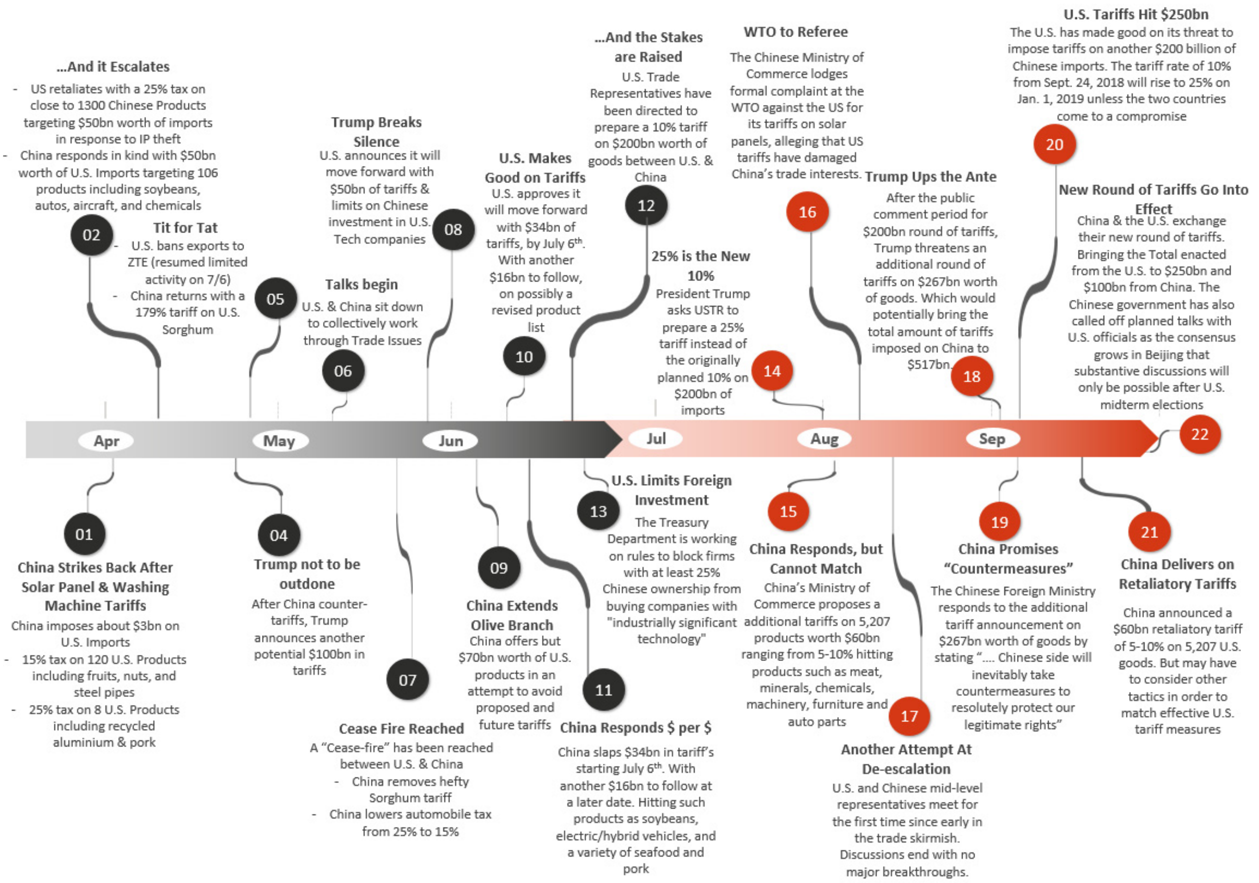
Regional credit conditions

What's changed?

The U.S.-China tariff dispute shows no signs of easing, and an all-out trade war that weighs on growth in the world's two biggest economies seems more likely than not. But the effect on GDP wouldn't be the whole story. Indeed, financial markets, which are forward-looking, have at times been rattled by the trade rhetoric and actions.

Meanwhile, President Trump, after informing Congress of his having struck a deal with Mexico, threatened to leave Canada out of a renegotiated North American Free Trade Agreement, saying "If we don't make a fair deal for the U.S. after decades of abuse, Canada will be out."

US-China Trade Dispute Snapshot



Source: S&P Global Ratings. Note: Does not reflect all trade actions

Assessment of key risks

Trade: Beyond the possibility of a full-blown trade war with China and increased tensions with the U.S.'s other largest trade partners, we see the biggest risks to North American credit conditions as rising corporate debt, the prospect for faster-than-forecast interest rate increases, and imbalances in Canada's housing market.

Debt: As declining credit quality heightens debtor's sensitivity to rising borrowing costs, U.S. nonfinancial corporate debt has reached a new high of $14 trillion, or 73.5% as a share of GDP. The pick-up in leveraged lending and speculative-grade bond issuance could amplify credit stresses if investors become more risk-averse, eroding borrowers' market access- especially those at the lower end of the credit rating spectrum

Interest Rates: Though the Federal Reserve has been measured in its tightening of monetary policy so far—and financial markets' response has been equally subdued—borrowers will at some point face higher rates and a potential funding-liquidity squeeze.

Canada Housing: With elevated prices hampering home affordability and Canadian households holding a record C$2.1 trillion in credit market debt, housing market imbalances remain a key vulnerability for the country's economy.

Financing conditions

Through August, nearly all indicators of financing conditions remained favorable for corporate borrowers, and leading indicators of near-term defaults point to a declining default rate through the first half of next year. Corporate bond issuance (across non-financials and financial services) will likely fall short of last year—however, last year's very strong levels would be difficult to match.

The Fed's latest rate hike brings the benchmark federal funds rate to 2.0%-2.25%. This marks the eighth increase since December 2015, and most observers at this point expect another at policy makers' December meeting. Though the Fed has pursued a predictable path thus far, with little impact on corporate yields, at some point higher rates will affect borrowers.

This may already be happening, as corporate bonds yields have crept up somewhat from their decade-long lows at the end of last year. We believe this gradual rise will persist, resulting in higher costs for corporate borrowers by year-end. That said, the spread on five-year speculative-grade bonds finished August at 319 basis points (bps), little change from the 328 bps at the end of last year (see chart 1). And while 10-year investment-grade spreads have widened 21 bps since the end of last year to 137 bps, they're still near multiyear lows and have declined slightly since the start of the third quarter.

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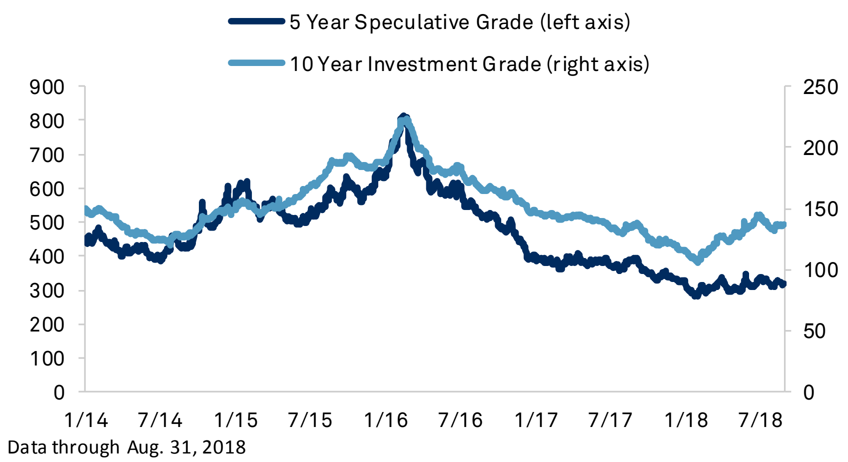
Chart 1

Investment-Grade and Speculative-Grade Corporate Bond Spreads (bps)



Source: S&P Global Fixed Income Research

Investors still favor floating-rate debt, continuing a trend that began alongside Fed rate hikes at the end of 2015. Leveraged loan issuance remains robust, and is keeping pace with last year's record. Spreads remain low, though with a recent, sharp uptick in those on institutional loans. And though unfavorable to lenders, the years-long trend of easy borrowing terms continues in this asset class, with more than three-fourths of deals classified as covenant-lite in August (that is, they lack the usual protections for lenders).

Meanwhile, the distress ratio (the share of spec-grade issues with option-adjusted composite spreads of 1,000 bps or more over Treasuries) remains low, reaching 5.7% in August. The telecommunications sector leads with the highest ratio, at near 16%, followed by the retail and restaurants sector at 14%. The latter accounts for the largest volume of distressed debt (at $13.3 billion) and had the steepest month-over-month increase, with three new distressed issues. Much of this distressed telecommunications debt is from just two issuers: Frontier Communications Corp. and Windstream Services LLC (a subsidiary of Windstream Holdings Inc.).

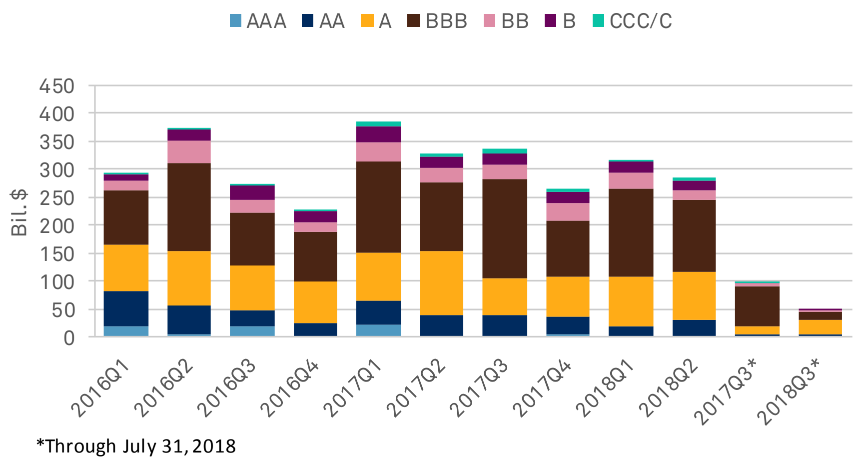
Total U.S. corporate bond issuance fell to $142 billion in the July-August period. These are typically the slowest months of the year (along with December), but even considering that, this is off from $224 billion at the same point in 2017 and is the lowest July-August total since 2014. Year to date, this puts 2018 off 19% relative to last year.

The majority of this decline is attributable to a near 20% drop-off in investment-grade issuance, with only the 'A' category seeing a slight increase. Meanwhile, spec-grade issuance is down an even larger 26% (see chart 2). Again, last year's totals were quite high, reaching nearly $1 trillion through August, and it was the first year since 2012 to see an annual increase in spec-grade issuance.

The fall season could be telling for issuance trends over the next 12 months. Many will hope for a rebound off of the prior two months' declines, but escalations in trade disputes, upcoming mid-term elections, and any unexpected monetary tightening could cause adverse market reactions and make investors skittish.

Chart 2

Quarterly Rated U.S. Corporate Bond Issuance



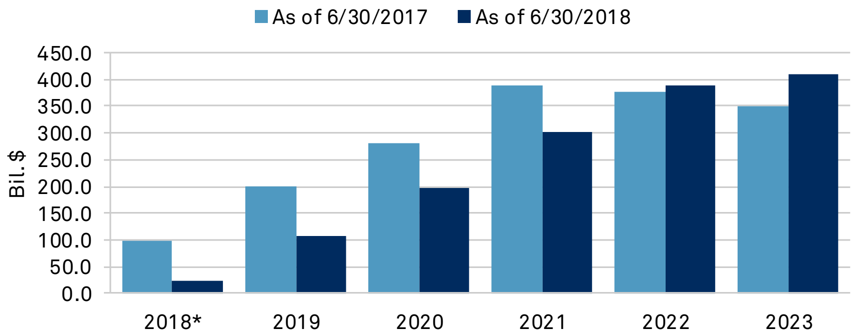
Sources: Thomson Financial and S&P Global Fixed Income Research.

As benchmark interest rates return to more normal levels and lenders regain stronger footing, funding liquidity could become tighter, and lower-rated borrowers would almost certainly find it harder to issue new debt. That said, it's too early to factor this into our base-case assumptions, and we believe U.S. corporate borrowers are well ahead of their maturing debt through 2019.

U.S. corporate borrowers, including financial and nonfinancial companies, have $4.9 trillion in rated debt coming due through 2023, with maturities rising to a peak of $1.04 trillion in 2022. About 29% of the total is spec-grade nonfinancial debt—which is naturally more susceptible to refinancing risk (see chart 3).

Chart 3

U.S. Speculative-Grade Nonfinancial Corporate Maturity Wall



Note: * 2018 maturities estimated as of 6/30/2018 reflect debt scheduled to mature in the second half of the year. Includes bonds, loans, and revolving credit facilities that are rated by S&P Global Ratings on the respective report date. Foreign currencies are converted to USD on the respective report period date.

Source: S&P Global Fixed Income Research

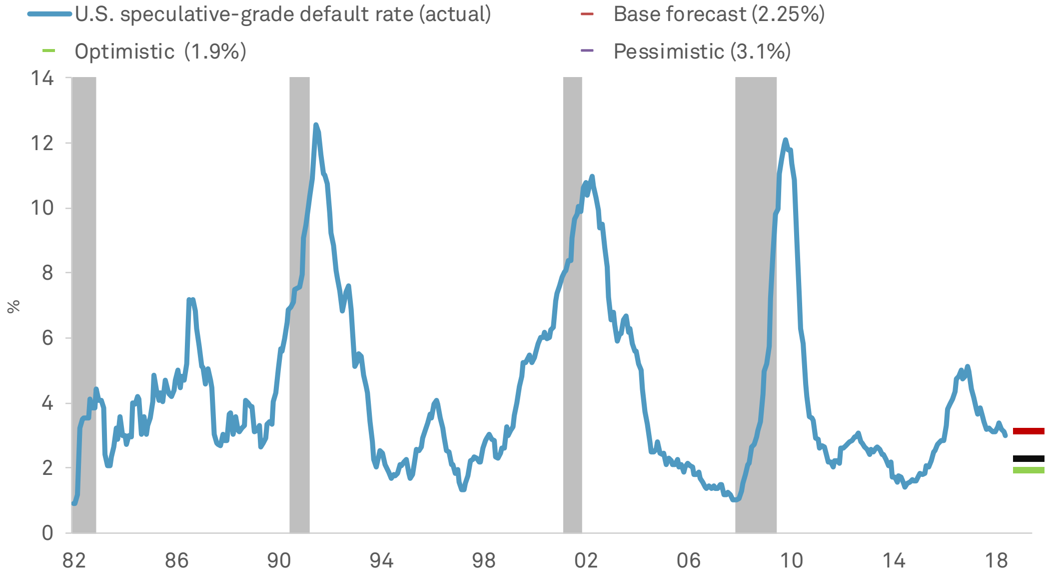
With accommodative financing conditions, U.S. companies have reduced the amount of speculative-grade debt set to mature in 2019 and 2020 by 36% over the past year. At the start of 2018, $78.2 billion spec-grade nonfinancial debt was set to mature during the year; and as of June 30, 2018, only $24.1 billion remains to mature in the second half of year (with nearly half in the 'BB' category).

S&P Global Fixed Income Research forecasts the U.S. trailing 12-month spec-grade default rate will fall to 2.25% by June 30, 2019, from 3% in June of this year (see chart 4). Nearly all leading indicators of near-term defaults are currently benign. However, risks remain in the longer-term, including a tighter monetary policy, a new tax code containing debt-deterring elements that will only become more restrictive in future years, and the waning positive effects on GDP of tax reform and the recent fiscal stimulus.

In addition to higher rates by the Fed, Treasury yields are heading toward an inversion of the yield curve. A negative yield curve has preceded most recent recessions in the U.S., as well as the last three peak default rates of over 10%. With this track record in mind, it's important to note there is typically a protracted lead time between the initial inversion and the peak in the default rate, usually exceeding 18 months.

Chart 4

U.S. Trailing-12-Month Speculative-Grade Default Rate And June 2019 Forecast



Shaded areas are periods of recession as defined by the National Bureau of Economic Research (NBER)
Sources: S&P Global Fixed Income Research and S&P Global Market Intelligence's CreditPro®

All of this is happening as corporate credit quality at the lower end of the scale is worsening. About 24% of the spec-grade corporate issuers in the U.S. are rated 'B-' or lower, up from about 16% four years ago, and 15% at the midpoint of 2007. This portion of the spec-grade universe has been growing steadily and is now at a high last seen during the financial crisis.

Macroeconomic developments and assumptions

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(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.)

U.S.

State of Play: With U.S. economic momentum remaining solid, S&P Global Ratings expects above-trend GDP growth this year and next—at 2.9% and 2.3%, respectively. The strong labor market, still-bullish consumer confidence, and favorable manufacturing sentiment all bolster this view.

Headline unemployment is at 3.9% and wages are finally showing significant gains, while August consumer confidence was at an 18-year high and core retail sales rose for a seventh straight month. The Institute for Supply Management manufacturing index also rose 3.3 points to 61.4 in August, with all components above the "neutral" rate of 50—and that's good news for new orders and shipments.

Despite the trade dispute, the world's biggest economy is on solid footing, and we forecast a strong third-quarter GDP growth reading of 3.2% after a blockbuster 4.2% in the April-June period, which will push the expansion toward record length.

That said, the U.S. tariffs, with retaliation from China, will likely reduce GDP growth this year and next. Assuming the 10% tariffs remain in place, we lowered our growth forecast for the year, albeit to a still-solid 2.9%, from 3.0% in our June forecast (and still almost 50 bps higher than our March forecast), and we expect the economy to expand 2.3% next year. If the tariffs increase to 25%, as the White House has threatened, GDP growth will likely slow an additional 20 bps to 2.1% next year.

Against this backdrop, we expect inflation to climb through next year on the stronger economy, boosted by fiscal spending and higher healthcare costs. Higher prices related to tariffs will also add modest upward pressure. Core personal consumption expenditures (PCE) inflation, excluding food and fuel, is now around the Fed's target of 2%. We expect core Consumer Price Index (CPI), which usually runs about 25 bps hotter than core PCE, to jump from 1.8% last year to 2.2% this year, slowing to 2.1% the following year.

Outlook: After a banner second-quarter GDP, we expect annualized expansion of 3.2% in the July-September period as households and businesses spend some of their windfall from recent tax cuts. But we don't expect this boost to last long; we forecast U.S. GDP growth to slow to below its long-run potential of 1.7% by 2020. There is also a risk that growth will be even lower—and inflation hotter—than we forecast, which could pose a problem for Fed policy makers.

Risks: The direct effects of the U.S.-China tariffs won't likely materially change the macroeconomic backdrop for the U.S. economy or overall corporate credit health. Related pressures will likely boost consumer price inflation only marginally and weigh a bit on already-sluggish U.S. productivity growth. The knock-on effects are somewhat more troubling, given that it's unclear how industries that rely on imported inputs might react. In a full-blown trade war, corporate spending could dry up and supply chains could be disrupted or severed, which could harm production efficiency, boost costs, and result in less need to hire workers.

Our quantitative assessment of recession risk in the next 12 months was 12% in August, up from 10% in May. Our qualitative assessment, which recognizes hard-to-measure policy mistakes, remains at 10%-15%—with the risk of a trade war pushing it closer to the higher end of that range. But given the age of the current credit cycle, the economy may be running out of room to expand at an above-trend pace.

Moreover, the flattening of the yield curve on its own shouldn't be a surprise, as it normally happens during tightening cycles, but it has raised the question of how markets will respond and whether we may see the yield curve invert, which is generally considered a reliable predictor of a coming recession.

To be sure, there are few signs that the economy will tip into recession in the short term, but such a risk is intensified—and a financial shock (e.g., a sudden bear market in stocks, housing slump, or oil price spike) could be enough to tip the scales. We remain concerned that as the boost from fiscal stimulus wanes next year and inflation picks up, the Fed would be forced to raise benchmark borrowing costs faster than the economy can absorb. For now, we expect the Fed to continue along its current path, raising rates a total of four times this year and three times in 2019.

Canada

State of Play: Real GDP grew at an annual pace of 2.9% in the second quarter, or double the previous quarter's 1.4% increase. Business investment held up, while exports shifted into higher gear and job gains encouraged consumers to spend more despite seeing their purchasing power squeezed by rising borrowing costs, higher headline inflation, and slower real wage gains. Canada's natural resource producers are benefitting from higher (energy and non-energy) commodity prices, which have also strengthened the country's trade terms and net exports. We see GDP growth holding near 2% for the remainder of the year and averaging 2% or slightly higher for all of 2018.

The Bank of Canada (BoC) nudged its policy rate up a further 25 bps, to 1.5%, in July. The rate now stands a full percentage point above where it was in mid-2017, but this hasn't benefitted the Canadian dollar. It's depreciated about 3% versus the U.S. dollar in that time, losing ground to the greenback in part because the target range for the U.S. federal funds rate (1.75%-2.0%) remains above the BoC's policy rate. Also weighing on the Canadian dollar are escalating trade tensions between the U.S. and its major trading partners (including Canada), which seem to be exposing a larger share of global GDP to trade and investment disruptions.

Outlook: The outlook for next year and beyond depends on whether business spending and trade remain growth drivers for Canada. In our baseline outlook, we see investment spending lifting growth as businesses address growing capacity constraints, retool their production platforms, and pursue growth opportunities in key markets. These investments could help lift lagging productivity growth above its long-term trend of 1%, keep a lid on inflationary pressures, and allow the economy to sustain growth above 2%. For now, we assume GDP growth will continue to average close to 2% through 2020. In our base-case scenario, we see Canadian and U.S. negotiators eventually resolving the current impasse and a tri-lateral NAFTA deal preserving cross-border trade and investment links between the U.S., Canada, and Mexico.

Even if faster productivity growth isn't in the cards for next year, we don't see inflation breaching the BoC's target range of 1%-3%. Inflation readings are getting a lift from Canada's 25% retaliatory tariffs on C$5.6 billion of steel imported from the U.S. and 10% on an additional C$11 billion against imports of aluminum and other consumer goods. However, Statistics Canada sees the direct impacts of these tariffs adding just 0.07 percentage points to headline CPI annually. Rising interest rates and borrowing costs are also contributing to recent inflation gains, but the largest share comes from energy prices rebounding from the depressed levels of a year ago.

With core inflation remaining near the BoC's 2% target, we expect only one more rate hike this year and the central bank's policy rate to finish 2018 at 1.75%. Further increases will take it up to 2.5% by the end of next year.

Risks: Housing market imbalances remain a key vulnerability for Canada's economy, with rising borrowing costs and elevated price-to-income multiples squeezing home affordability, especially in Toronto and Vancouver. The NAFTA renegotiation and potential contagion from global trade tensions are similarly a risk for Canada's trade-oriented growth prospects.

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- Continued favorable economic and financing conditions will support corporate creditworthiness through year-end, although the potential for improvement is limited at this late stage in the credit cycle.
- Elevated leverage is a key headwind--particularly for those issuers at the lower end of the credit spectrum. Periods of volatility, especially this late in the credit cycle, could hamper financing conditions and constrain market access.

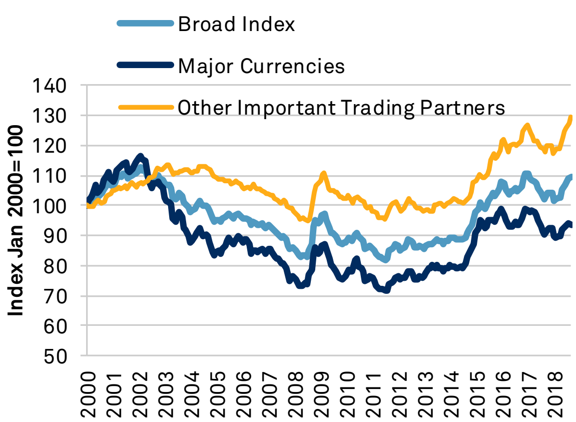
What's changed?

In the latest round of the U.S.-China trade dispute, the U.S. placed tariffs on $200 billion of Chinese goods (at 10% rates that rise to 25% on Jan. 1), with China imposing tariffs of 5%-10% on $60 billion of American goods as retaliation. Moreover, the U.S. continues to raise the possibility of extending new tariffs to all imports from China. In NAFTA renegotiations, the U.S. reached a preliminary agreement with Mexico while continuing to hold talks with Canada. President Trump has informed Congress of his intent to sign a deal with Mexico—with or without Canada—but it's unclear how tenable this agreement is since Congress appears to prefer a deal that includes Canada. Meanwhile, U.S.-EU trade tensions have cooled off as the U.S. held off on tariffs on European autos while the parties discuss lowering other trade barriers.

The dollar has continued to strengthen, which is a profits headwind for U.S. multinationals and exporters. It is also weighing on commodity prices that typically move inversely with the dollar (although less so with oil prices lately). The climb in the dollar continues to stoke emerging market turbulence that risks spreading beyond Argentina and Turkey to other vulnerable countries (such as India, Indonesia, and South Africa).

Chart 5

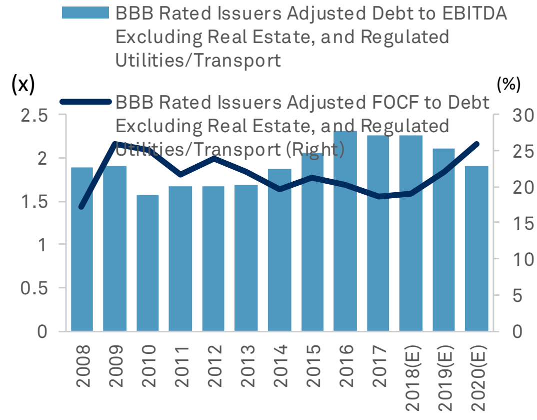
Trade-Weighted U.S. Dollar Index



Source: Federal Reserve Bank of St. Louis, S&P Global Ratings

Chart 6

Median 'BBB' Rated Debt To EBITDA and FOCF To Debt



Source: S&P Global Ratings. Note: Total adjusted debt refers to balance-sheet debt of 'BBB' rated issuers. 2017 adjusted financials, may contain projected financials. Includes private rated companies. E-Estimated.

Key assumptions

Largely favorable credit conditions given our assumptions of above-trend U.S. growth this year and next, continued, gradual rise in borrowing costs, and supportive financing conditions.

Key risks

The main macro risks for corporates are more aggressive Fed rate hikes than expected, financial market volatility/asset market repricing, and the effects of ongoing trade disputes.

Escalation of the conflict with China and other trading partners and NAFTA renegotiations pose risks to trade, investment and supply chains, and confidence. In particular, the trade rift between the U.S. and China could expand beyond tariffs on goods to services, cross-border investment, and other non-tariff actions that would heighten operational risk, reduce market access, or decrease revenues for U.S. companies. For example, the Chinese government could persuade the country's consumers to boycott select American products and services, or it could delay or make it more difficult for U.S. companies to obtain permits to operate or expand in China.

U.S. corporates are carrying a record amount of debt and leverage on their balance sheets, as many companies took advantage of historically low borrowing costs after the financial crisis to embark on mergers and acquisitions (M&A) given the limited potential for organic growth. Thus, excessive leverage is a key headwind—particularly for those at the lower end of the credit spectrum. Periods of volatility, especially this late in the credit cycle, could hamper financing conditions and constrain market access, giving rise to defaults.

Moreover, the rapid expansion in speculative-grade bond issuance and leveraged lending, as well as cov-lite deals, could amplify credit stress. The proliferation of cov-lite to the direct-lender middle-market space could ultimately translate into lower recoveries in a protracted downturn. Many permanent capital vehicles have also provided financing to the corporate credit market over the past couple of years. While not vulnerable to redemptions, the lack of transparency with their portfolios could lead to false comfort about their asset quality, or add to a "confidence risk."

Debt in the 'BBB' ratings category (which includes 'BBB+' and 'BBB-') has also swelled in the past decade, and investors have become increasingly concerned about the ramifications when the credit cycle turns. The worry is that if sizable 'BBB' issuers fall to spec-grade in a downturn, there could be challenges in the non-investment-grade market absorbing these positions, and that it will lead to much higher financing costs for lower-quality spec-grade borrowers seeking financing at a time when "fallen angels" are transitioning.

In this regard, our analysis of 'BBB' risk characteristics shows that median leverage in this category has increased to 2.3x at the end of last year from 1.9x in 2008 (excluding real estate, regulated transmission/transport, and regulated utilities, which can handle higher leverage because cash flows are more predictable). This remains in line with our parameters for the 'BBB' rating category. In addition, business risk profiles have strengthened, and free operating cash flow (FOCF) relative to debt for 'BBB' issuers is slightly higher.

What to look for over the next quarter

We expect ratings to remain generally stable, with pockets of weakness—particularly in consumer products and retail. We think continued favorable economic and financing conditions will support corporate creditworthiness through year-end, although any improvement would be limited at this stage in the credit cycle.

The amount of debt coming due in the near term is manageable, as U.S. corporates have pushed out their maturities. Rated debt maturities now peak in 2022—a year later than our estimates from last year. Refinancing risk is limited overall and most significant in certain retail segments.

In addition to the risks arising from trade policy, there's a potential for greater market volatility in the next quarter given the campaign rhetoric and policy uncertainty emanating from the U.S. midterm elections in November.

We are also monitoring if emerging markets turmoil remains relatively contained. More stressful conditions such a full-blown trade war, an even stronger dollar, or falling commodity prices could prompt a widespread run on emerging markets, with investors no longer differentiating for fundamentals.

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- U.S. and Canadian banks still benefit from higher interest rates, loan growth (as GDP grows), and fourth-quarter 2017 tax cuts.
- U.S. legislative changes regarding financial service regulation will only have a minor impact on BICRA and ratings.
- U.S. auto loans, credit cards, commercial real estate, and leveraged lending are areas to watch for emerging risk.
- For Canadian banks, "soft-landing" is continuing in the housing market, likely helped by tighter policies that took effect this calendar year.

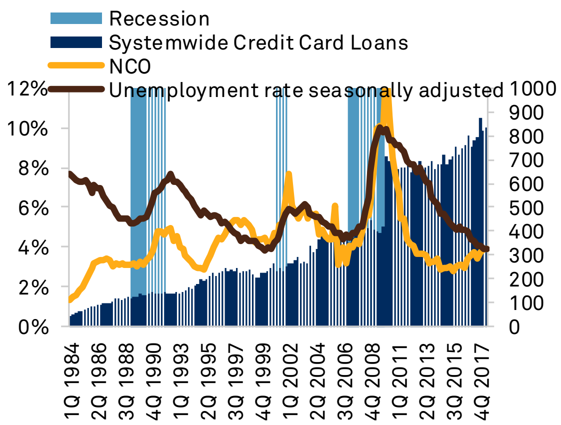
What's changed?

Among U.S. banks, there was one positive rating action and one negative in the third quarter. Currently, our ratings on seven U.S. bank operating companies have negative outlooks and five have positive outlooks, but the vast majority have stable outlooks.

Among Canadian banks, currently one has a positive outlook and one has a negative outlook, with the rest all being stable, including all Domestic Systemically Important Banks (DSIBs). Eligible senior bank debt issued or re-opened Sept. 23 or later by DSIBs will be subject to the "bail-in" power, but our base case is that this will have little impact on bank funding rates.

Chart 7

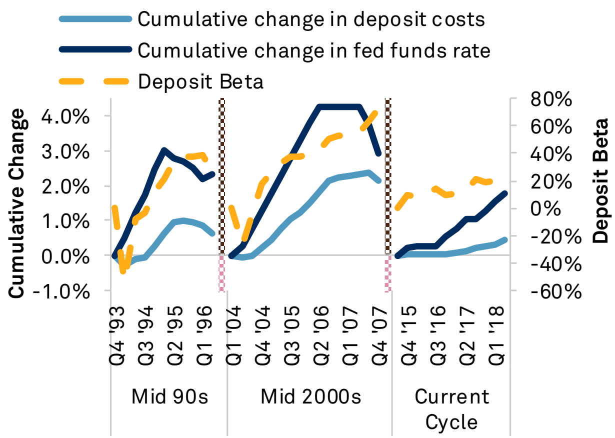
Post-crisis credit card loan growth has been robust



Source: FDIC; Federal Reserve Bank of St. Louis

Chart 8

Deposit betas may begin to rise more significantly



Source: S&P Global Ratings

Key assumptions

We expect interest rates to rise gradually, with GDP growth in line with our economists' forecasts. Importantly, we assume no major disruptions from NAFTA renegotiations.

We forecast loan growth to continue, roughly in line with nominal GDP growth. Credit losses have likely bottomed out and will gradually increase starting next year.

Key risks

Among our top risks are rising rates and the effect on market valuations and asset quality. Deposit betas could rise further or more quickly than current ratings assume (implying more interest rate risk for liability-sensitive banks).

Regarding NAFTA, a messy renegotiation could undermine confidence among banks' customers and affect business flows, although we believe this would be more important for Canadian banks than U.S. ones.

What to look for over the next quarter

We're closely watching to see whether rising interest rates may expose greater interest-rate risk than we previously assumed at liability-sensitive banks. We are also watchful for any sign of rising nonperforming assets or net charge-offs in identified "at-risk" loan sectors, particularly auto, commercial real estate, and credit card loans. Additionally, any U.S. regulatory appointments or actions that appear to indicate a significant loosening of standards might cause us to reevaluate our U.S. industry risk score.

Insurance

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- As we approach the final quarter of 2018, the financial strength of North American insurers remains strong, with broadly stable rating outlooks that reflect S&P Global Ratings' expectation for limited rating changes over the next 12 months.

What's changed?

Rating activity through the third quarter was affirmation-oriented, with some modest net upward movement year to date. Overall, the average financial strength rating for the portfolio resides in the upper half of the strong ('A') category.

Table 2

Sector	Average credit quality (financial strength rating)	% of ratings with stable outlook
Life	A+	80
Health	A-	75
Property/casualty	A	77
Global reinsurers	A+	80
Bond insurers	AA	100
Title insurers	A	66
Mortgage insurers	BBB	50

Source: S&P Global Ratings.

Key assumptions

Balance sheet strength remains a pillar of credit quality support for the portfolio, providing some protection from risks related to downside economic development, and more specifically the expansion or increase in the magnitude of current subsector challenges.

Key risks

Factors related to pricing, profitability, growth, M&A, and regulation/legislation continue to be areas of concern and analytical focus.

What to look for over the next quarter

The life sector is reflecting slow growth with pockets of opportunity. Outside of retail products, we expect pension risk transfers to be a growth area for insurers willing and able to manage the related risks. We also expect active M&A in the near term, supported by nontraditional buyers, legacy books for sale, and some insurers' desire for scale.

The health sector is reflecting better profitability but also contending with deal risk and lingering legislative/policy uncertainty. Still, we expect a sustained measure of performance strength to underpin credit quality for the remainder of this year, with operating performance migrating more broadly toward target or above-target margin ranges partly due to subdued medical trends and improved commercial medical loss ratios in that segment.

The stable credit quality in the property/casualty (P/C) sector hinges on insurers' efforts and commitment to produce underwriting profitability and very strong capitalization. After a prolonged period of pricing complacency leading to rate inadequacy in many product lines, pricing in most lines improved modestly through the first half of the year, which is in line with our expectations. Even though we expect pricing to continue to improve, our combined ratio forecast near 100% is dependent on a normalized level of natural catastrophe losses for the full year.

For reinsurers, weak market conditions have driven them to rethink their short- and long-term strategies. This has led many to pursue M&A, divest nonperforming businesses, diversify into less-commoditized lines of business, and embrace third-party capital. They've also adjusted risk exposures while shifting their underwriting appetite to primary and proportional reinsurance and away from non-proportional reinsurance, and they're actively managing their capital structures through share buybacks, special dividends, and refinancing their maturing securities with more cost-effective ones.

The bond insurer sector is benefiting from rising interest rates and growing retail demand. Rising interest rates, changes to the tax code, and demand for new infrastructure investment continue to underlie this stability, in our view. Year-to-date insured par is down due to less municipal bond issuance, which is due in part to lower refunding volumes caused primarily by tax reform.

We believe title insurers are benefiting from the ongoing economic expansion, a shift in the residential market to higher-premium purchase and higher real estate values, and improvement in commercial business. In terms of losses, the industry reported little change in loss provision and loss ratios in the 4%-6% range. Each company's effort to monitor operating efficiency combined with higher investment income driven by higher interest rates have helped to maintain profitability and strengthen capital.

Mortgage insurers continue to benefit from favorable trends in employment and housing, as well as growing income levels in many markets, which has led to more buying power for potential homebuyers. Delinquency rates generally decreased in the second quarter from the first three months of the year, and are below the second quarter of 2017. Strong earnings are helping build capitalization, supported by reinsurance and the insurance-linked note market.

Structured Finance

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- U.S. structured finance performance has been stable or improving.
- A strong economy has contributed to the health of the underlying collateral performance.
- Localized pockets of weakness could translate into mild performance deterioration.
- Geopolitical and certain macroeconomic risks could induce volatility in some markets.

What's changed?

U.S. structured finance performance has been stable or improving over the past few years, and we expect this to continue for the next year. A healthy consumer, low unemployment, still-low interest rates, and generally appreciating asset prices have contributed to positive collateral performance underlying the rated securities, albeit with some pockets of weakness.

Some signs of late-cycle behavior that we noted last quarter persist. These include weaker documentation/structural protections in collateralized loan obligations (CLOs) and leveraged loans, elevated interest-only (IO) lending in commercial mortgage-backed securities (CMBS), and weaker triggers/more 'B' rated classes in subprime auto asset-back securities (ABS) transactions.

The S&P CoreLogic Case-Shiller U.S. National Home Price NSA Index increased 6.2% year over year in June. While this is down slightly from the May reading, it remains impressive, and most analysts expect continued strong home-price appreciation throughout the next year, albeit at a slightly lower pace. As home prices continue their surge—the U.S. median home sale price has increased almost 7% year over year—affordability remains a major theme across U.S. housing markets.

Key risks

Some potential risks that could derail the continued recovery of structured finance include the NAFTA renegotiation, Brexit uncertainty, rising interest rates, and any market volatility that affects liquidity.

A key risk is that an external factor (e.g., trade, geopolitics, etc.) will cause economic growth and/or consumer confidence to slow (or reverse), leading to a decline in asset prices and deteriorating macroeconomic conditions—and thus, weaker loan performance in the form of more defaults and lower recoveries. Rising interest rates could also weaken marginal borrowers' ability to pay.

The National Assn. of Realtors' Pending Home Sales Index dropped 2.3% year over year in July, marking the seventh straight month of annual declines. The problem is that years of inadequate supply in markets along with strong job growth are driving home prices to unaffordable levels. Indeed, imbalances between supply and demand coupled with reduced affordability could dampen home sales for the remainder of the year, according to Freddie Mac's August forecast.

Interest rates are also playing a role in affordability and homeownership. The conforming fixed mortgage rate is now approaching 5%, which is the highest it has been in over seven years. Because mortgage rates have gone up over 100 bps since their post-recession low, the total mortgage payment (principal and interest) on the median-priced home has increased substantially. It is expected that rates will continue to rise in the near-term. Meanwhile, real disposable income is forecast to increase less than 3% over the coming year, meaning that affordability for the U.S. home buyer will continue to erode.

On the bright side, mortgages are performing well. Despite a modest increase in foreclosures, improvement in delinquencies brought the total non-current loan population (30-plus days delinquent or in active foreclosure) to the lowest level since March 2006.

When the cycle turns, our base-case expectation (which would be for a more mild recession than 2007–2009) is for higher numbers of speculative-grade tranche downgrades across ABS, CLO, CMBS, and RMBS, with some isolated risk to low investment-grade classes.

Key assumptions

We primarily see continued growth in consumer and business confidence, which should support positive economic activity. Although we may see some headwinds from geopolitical uncertainty in the second half of the year, we continue to forecast approximately $1 trillion of global securitization by year-end 2018

What to look for over the next quarter

With GDP growth strong and unemployment low, structured finance markets are forecast to perform well over the foreseeable future. As of the second quarter, homeownership across the U.S. was 64.3%, up from recent lows, but still below the long-term average. This is down substantially from the record-high in 2006 when the rate approached 70%. Largely for this reason, U.S. household debt service remains at acceptably low levels.

Public Finance

- State fiscal conditions have improved as a result of stronger-than-anticipated revenues and a slowdown in new Medicaid enrollments, though both phenomena may be temporary.
- Local government credit quality has been stable, due in part to states' healthy fiscal conditions and good national economic conditions.

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What's changed?

For the U.S. states, the second-quarter (late in the states' fiscal year) pickup in economic growth coincided with stronger tax collections. The additional revenue substantially alleviated much of the near-term fiscal imbalance that had come to strain the credit quality of numerous states despite the ongoing economic expansion. Additionally, with labor markets now essentially at full employment, states have seen a leveling of the enrollment trends for Medicaid, which is an important driver of overall state expenditures. Longer term, however, Medicaid costs will grow faster than state tax revenues, and will thus continue to pressure state finances.

When state government performance is strong, it generally benefits local governments through state support for schools, revenue sharing, etc. Despite this stable foundation, an expanding list of tariffs is causing uneven economic stress in different parts of the country, although it hasn't hurt credit quality for local governments to date.

Table 3 **States Most Exposed To Prolonged Trade War With China**

	Share of GDP in goods production	Above-average exports to China
South Carolina	23	Yes
Michigan	25	Yes
Oregon	29	Yes
Louisiana	30	Yes
Tennessee	21	Yes
Kentucky	26	Yes
Indiana	34	No
Wisconsin	25	No
Ohio	23	No
Minnesota	21	No

Source: Oxford Economics/US Census Bureau

Key assumptions

We expect continued broad-based economic expansion, with steady job growth of slightly less than 200,000 new payroll positions per month. In this light, states are operating in a stronger revenue environment—though some of the gains reflect nonrecurring factors—providing a solid basis for local governments.

Key risks

The specter of a more intense or prolonged trade war with China is a risk with outsized implications to states with manufacturing-based economies. Those with above-average exports to China and with more goods-producing (as opposed to service-based) economic bases are at greater risk in this scenario, A sharp decline in consumer confidence--whether because of a trade war or any other trigger event--leading to a selloff in equity markets could undermine state revenue trends, most of which are built upon the assumption of continued gradual market appreciation. Inexorable upward pressure on mandatory expenditures for Medicaid, pension contributions, and retiree health benefits costs is likely to outpace the states' recurring revenues. Thus, a recession is not necessary for states to experience renewed fiscal stress--the baseline economic forecast would likely be enough.

As detailed in the table above, prolonged exposure to the China tariffs could create a more meaningful impact in some states than others, affecting local governments differently as well. To date, agriculture has been one of the hardest-hit areas from the tariffs, although federal subsidies should help support farm communities that would otherwise be disproportionately affected. The uneven distribution of these effects will be felt most in credits already struggling to sustain budgetary balance, particularly if there is no federal assistance to ease the changes. In those cases, if the municipalities also face rising pension costs and/or a backlog of infrastructure needs, it could easily exacerbate any emerging structural deficits.

For U.S. ports, we had previously highlighted several key risks including tariffs or changes in U.S. trade policy. We believe most of the direct effects from announced tariffs will be limited. While trade volumes were strong in the first half of 2018, U.S. import growth rates slowed considerably year over year in August 2017–June 2018 and efforts to import goods and beat the tariff increase is coming to an end. Larger credit concerns would be the potential for retaliation that escalates into a trade war. We believe this would depress trade volumes, hurting port revenues and credit quality.

It is estimated that the expanded 301 tariffs on cargo moving through U.S. ports – included the additional $200 billion and China's retaliatory response – would cover 8.4% of trade through US ports measured by value. For California ports, it is estimated that it would affect 20% of containerized cargo with $63.6 billion of trade value.

U.S. port operators we rate operate as enterprises with financial covenants that require revenues be increased or expenses decreased to generate positive cash flows, and many larger container ports benefit from minimum annual guarantees from their largest shipping line tenants.

What to look for over the next quarter

Whether final enacted state budgets for fiscal 2019 achieve structural balance with sufficient recurring revenues to support ongoing spending commitments is a key leading indicator of state fiscal health.

As storm season hits its stride, we expect that impacts from any major weather events may be forthcoming. While most municipalities have shown notable resilience to all but the strongest storms, communities experiencing a direct hit are more likely to see some credit deterioration, particularly in areas with limited economic diversity.

Public Finance - Canada

Overall, we expect credit conditions among Canadian provinces to remain mostly stable through year-end, although some provinces still have fiscal consolidation challenges and maintain high debt levels.

We expect Canada, the U.S, and Mexico to reach a trade deal that largely preserves existing cross-border production chains and capital flows. This continues as our base-case scenario as any disruption on trade agreements could eventually affect some province's economic growth. The province of Ontario has the most at stake, considering 81.7% of its exports went to the U.S. last year (mainly to Michigan and California).

While the U.S. is still pushing to implement more protectionist trade policies, there is still opportunity to reach an agreement on NAFTA. Our base case is that Canada will maintain a strong negotiation strategy toward key economic sectors and that the negotiations are unlikely to hurt provinces' economic performance in 2018-2019—even as uncertainties could affect the pace of investment decisions in the short to medium term.

We think that Canadian provincial governments will continue to be the driving force behind increasing borrowing needs this year and next. This growing share of debt will be driven by the provinces' fiscal deficits and borrowing tied to multiyear infrastructure plans. Subnational debt in Canada, most of which is provincial, is likely to account for about 60% of net general government debt in 2018. With very few exceptions, we believe that worst of fiscal deficit period for provincial governments is behind us.

Related Research

- Credit Conditions Asia-Pacific: Tighter, Weaker, Riskier, Sept. 27, 2018
- 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
- Global Financing Conditions: Issuance Is Down 5.7% Through July 2018, Aug. 30, 2018
- Despite An Aging Credit Cycle, The U.S. Speculative-Grade Corporate Default Rate Could Fall To 2.25% By June 2019, Aug 27, 2018

This report does not constitute a rating action.

Appendix: Ratings trends and surveys

North America Banking Industry Trends

U.S.	BICRA Group 3/10	Canada	BICRA Group 2/10
Economic Risk Factors	Industry Risk Factors	Economic Risk Factors	Industry Risk Factors
Score 3	Score 3	Score 3	Score 2
Trend Stable	Trend Stable	Trend Stable	Trend Stable

Note: Our BICRA Groups, Economic risk scores, and Industry risk scores are each classified '1' through '10', from lowest- tc highest-risk. Economic and Industry risk trend are each classified as stable, positive or negative. For more information pleas see Banking Industry Country Risk Assessment Update: Sep 2018

North America Nonbank Financial Trends

Negative	Stable to Negative	Stable	Stable to Positive	Positive
	Finance companies	Asset managers		

Note: Sector outlook indicates credit rating trends expected over the coming 12 months. Stable to Positive (Stable to Negative) outlook indicates potential for a modest number of rated entities in the sector to be upgraded (downgraded). Positive (Negative) outlook indicates potential for a material number of rated entities in the sector to be upgraded (downgraded). Arrows (if displayed) indicate direction of change in sector outlook from previous quarter.

North America Corporate Sector Trends

U.S.

Negative	Stable to Negative	Stable	Stable to Positive	Positive
Healthcare services; Retail; Consumer non-durables	Capital goods; Telecom; Media and entertainment; Consumer durables; Pharmaceuticals	Aerospace and defense; Auto OEMs and Auto suppliers; Forest products; Leisure and sports; Regulated utilities; REITs; Technology; Transportation; Oil and gas; Unregulated (merchant) power; Chemicals; Building materials	Homebuilders; Midstream energy; Metals and mining	
			Oil refineries	

North America Corporate Sector Trends

Canada

Negative	Stable to Negative	Stable	Stable to Positive	Positive
Media and entertainment; Unregulated (merchant) power	Midstream energy; Oil and gas	Forest products; Retail; Building Materials; Transportation (Canadian airlines); Transportation (Canadian rails); Utilities; Telecom; Chemicals	Metals and mining	

Note: Sector outlook indicates credit rating trends expected over the coming 12 months. Stable to Positive (Stable to Negative) outlook indicates potential for a modest number of rated entities in the sector to be upgraded (downgraded). Positive (Negative) outlook indicates potential for a material number of rated entities in the sector to be upgraded (downgraded). Arrows (if displayed) indicate direction of change in sector outlook from previous quarter.

North America Insurance Trends

Negative	Stable to Negative	Stable	Stable to Positive	Positive
		Life Insurers; Property & casualty insurers; Title Insurance; Reinsurers; Bond insurers; Health insurers	Mortgage insurers	

Note: Sector outlook indicates credit rating trends expected over the coming 12 months. Stable to Positive (Stable to Negative) outlook indicates potential for a modest number of rated entities in the sector to be upgraded (downgraded). Positive (Negative) outlook indicates potential for a material number of rated entities in the sector to be upgraded (downgraded). Arrows (if displayed) indicate direction of change in sector outlook from previous quarter.

U.S. Public Finance Trends

Negative	Stable to Negative	Stable	Stable to Positive	Positive
		Local governments; States; Health care; Higher education; Housing; Electric utilities; Water and sewer utilities; Airports and ports; Garvees		Toll roads and bridges

Note: Sector outlook indicates credit rating trends expected over the coming 12 months. Stable to Positive (Stable to Negative) outlook indicates potential for a modest number of rated entities in the sector to be upgraded (downgraded). Positive (Negative) outlook indicates potential for a material number of rated entities in the sector to be upgraded (downgraded). Arrows (if displayed) indicate direction of change in sector outlook from previous quarter.

North America Structured Finance Trends

Residential mortgages

Negative	Stable to Negative	Stable	Stable to Positive	Positive
		RMBS - Servicer advance; RMBS Re-REMICS	RMBS	

Commercial mortgages

Negative	Stable to Negative	Stable	Stable to Positive	Positive
		CMBS - Canadian conduit/fusion; CMBS - large loan/single borrower	CMBS - U.S. conduit/fusion	

Asset-backed securities

Negative	Stable to Negative	Stable	Stable to Positive	Positive
		ABS - auto loans; ABS - auto lease; ABS - credit cards; ABS - unsecured consumer loans; ABS - FFELP student loan ; ABS - private student loan; ABS - commercial equipment; Asset-backed commercial paper		

Structured Credit

Negative	Stable to Negative	Stable	Stable to Positive	Positive
	Tobacco	CLOs; Timeshares; Small business; Transportation		

Note: Sector outlook indicates credit rating trends expected over the coming 12 months. Stable to Positive (Stable to Negative) outlook indicates potential for a modest number of rated entities in the sector to be upgraded (downgraded). Positive (Negative) outlook indicates potential for a material number of rated entities in the sector to be upgraded (downgraded). Arrows (if displayed) indicate direction of change in sector outlook from previous quarter.

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