S&P Global Ratings

Credit Conditions:

Global Conditions Have Proven Resilient As Tensions Rise; How Long Can it Last?

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North America

- Trade tensions resulting from new U.S. tariffs pose risks to benign credit conditions even though direct impacts for the U.S. could be minimal
- The stronger near term outlook increases the likelihood that U.S inflation will move up and the Fed moves its policy rate up four times this year
- Recent developments could break the impasse in NAFTA negotiations and bolster Canada's growth prospects, mitigating risks of high consumer debt disrupting the economic expansion

Europe

- Credit conditions have continued to benefit from the broad based recovery in Europe, albeit with some Brexit related headwinds in the U.K
- Global trade tension is rising rapidly and could reduce risk appetite and fuel financial market volatility, while geopolitical risks remain problematic
- A weak U.S. dollar and strong euro is pressuring European exporter's competitiveness and making the ECB's task of generating higher headline inflation more difficult

Latin America

- Credit conditions in Latin America remain favorable, supported by domestic consumption and an advantageous global economy
- Although Mexico is exempt from U.S. steel and aluminum tariffs, the increased possibility for additional tariffs, trade skirmishes
- Elections may bring some volatility to debt markets and perhaps higher funding costs and disrupt otherwise favorable financing conditions

Asia-Pacific

- Fears of a China-U.S. trade war cloud otherwise positive momentum in the Asia-Pacific's macroeconomic outlook, financial conditions, and sector trends
- Asia-Pacific growth is mixed -- India (strong, led by investment), Australia (mediocre, held back by soft investment, net exports), while exports, industrial production lift the Tiger economies
- Despite marginally tighter credit standards in emerging Asia, financing conditions remain favorable

While global credit conditions have so far proven resilient in the face of geopolitical tensions and other risks, the question becomes: Can this hold true as pressures—specifically with regard to trade—intensify?

S&P Global Ratings' Top Global Risks include the possibility of trade and investment interruption, related primarily to U.S. President Donald Trump's recent imposition of stiff tariffs against China; increased asset price volatility and the possibility of liquidity reversals; and geopolitical tensions, specifically involving North Korea and Russia.

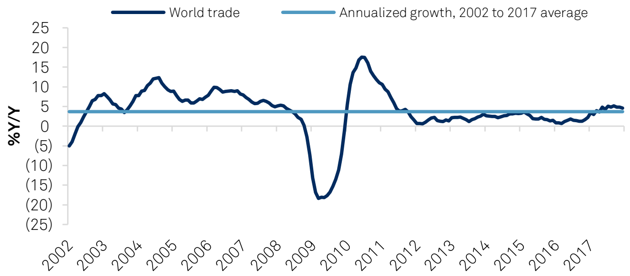
Top Global Risks

Trade and investment interruption

Risk level	Very low	Moderate	Elevated	**High**	Very high
Risk trend	Decreasing	Stable	**Increasing**		

U.S. steel and aluminum tariffs spiked protectionist sentiment and the threat of retaliation from China as it faces duties on other products amid U.S. allegations of China's unfair trade practices and intellectual property theft. Rising U.S. trade tensions with Europe could also erode confidence or cut global investment.

Spread of retaliatory tariffs across multiple sectors could cut trade contribution to global growth



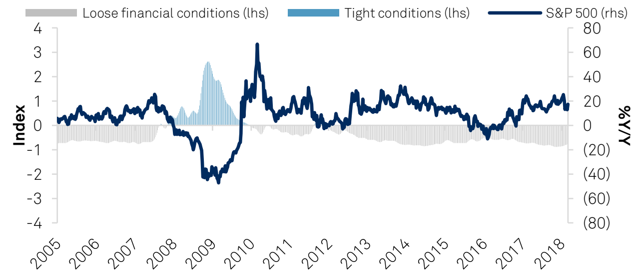
Source: Global Trade Alert.

Asset price volatility and liquidity reversal

Risk level	Very low	Moderate	Elevated	**High**	Very high
Risk trend	Decreasing	**Stable**	Increasing		

Portfolio adjustments to rising rates and Fed quantitative tightening remain orderly. Stable market and funding liquidity are supporting financial conditions. The U.S. economy overheating and rates spiking still seems unlikely so risk appetite is curbing volatility despite high real estate and financial asset values.

Accommodative financial conditions and positive asset returns persist despite rate rises



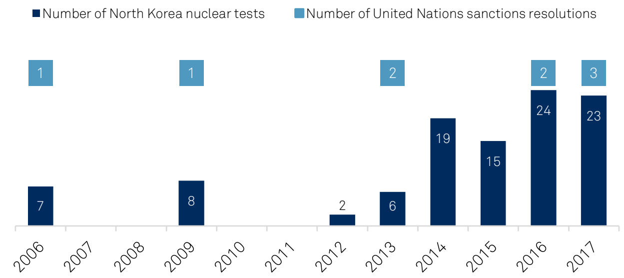
Sources: Chicago Fed National Financial Conditions Index, S&P Global.

Geopolitical tensions

Risk level	Very low	Moderate	Elevated	**High**	Very high
Risk trend	Decreasing	**Stable**	Increasing		

Proposed U.S.-North Korea meeting: Trump is likely to repeat his demands for denuclearization, while Kim looks to negotiate relief from punishing sanctions. North Korea's persistent defiance is a challenge to talks yielding a peace deal. Diplomatic expulsions, sanctions put more strain on Russia-UK/U.S. relations.

International community exerts maximum pressure, steps up sanctions against North Korea nuclear tests



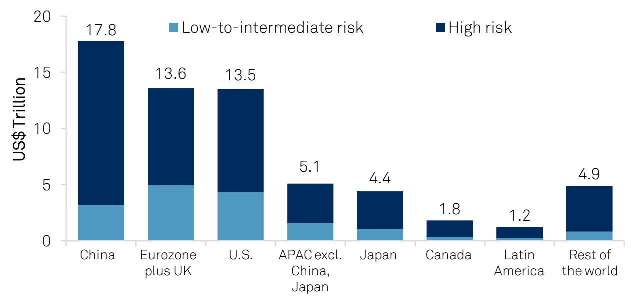
Sources: Council on Foreign Relations, S&P Global Ratings.

China debt overhang

Risk level	Very low	Moderate	**Elevated**	High	Very high
Risk trend	Decreasing	**Stable**	Increasing		

Credit growth appears to be slowing. Still, China's high-risk nonfinancial corporate debt now represents 30% of the world's total, exceeding Europe and America's 20% share. While China's debt is largely domestic-funded, a disorderly deleveraging could destabilize asset and commodity markets.

Nonfinancial Corporate Debt



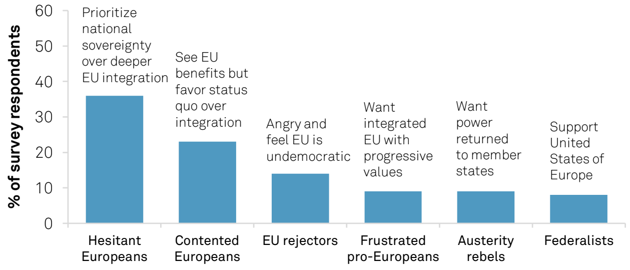
Sources: Bank for International Settlements, S&P Global Market Intelligence, S&P Global Ratings.

Populism and anti-globalization sentiment

Risk level	Very low	Moderate	**Elevated**	High	Very high
Risk trend	Decreasing	**Stable**	Increasing		

The Eurozone has yet to cross the populist Rubicon, but risks remain elevated with Italy's insurgent 5 Star party, gaining the largest number of seats in the recent indeterminate election and Germany's AfD now the official opposition. Attitudes toward further EU integration remain mixed.

Europe's political tribes and diversity of views on further EU integration



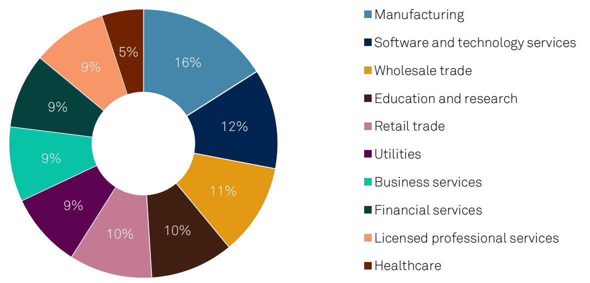
Sources: Chatham House, The Royal Institute of International Affairs Survey.

Cybersecurity threats to business activity

Risk level	Very low	Moderate	**Elevated**	High	Very high
Risk trend	Decreasing	**Stable**	Increasing		

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

Widespread Cloud Usage Across Sectors Highlights Systemic Dimension Of Cyber Threat



Source: Cyence.

*Risk level generally has a 12-24 month horizon. §Risk trend reflects our current view on whether the risk level could increase or decrease over the next 12-months. Source: S&P Global Ratings.

S&P Global Ratings' Credit Conditions Committees meet quarterly to review macroeconomic conditions in each of four regions (North America, Europe, the Middle East, and Africa, Asia-Pacific, and Latin America). Discussions center on identifying credit risks and their potential ratings effects on various sectors, as well as borrowing and lending trends for businesses and consumers. Regional highlights presented in table 1 summarize some of the main factors we see influencing credit conditions over the course of 2018.

Table 1

Regional Highlights

	North America	Europe, Middle-East and Africa	Asia-Pacific	Latin America
Risks and imbalances	Tensions resulting from U.S. tariffs could see retaliatory measures that strain global trade and investment Proposed U.S.-North Korea talks is encouraging, but North Korea's persistent defiance on denuclearization remains a challenge to a peace deal The U.S. retracted its contentious demand for auto imports from Canada, Mexico to contain 50% U.S. content and this could break the impasse in the stalled NAFTA renegotiation Impact of additional mortgage rule tightening on overvalued house prices in Canada	Exogenous shocks such as the neo-mercantilist policy bias of the U.S. administration could threaten the Eurozone recovery Brexit remains an important regional risk although we see it as a reduced risk near term A deteriorating state of Russian relations with the West and the possibility of the U.S. refusing to extend the Iran nuclear accord is a concern for stability Eurosceptic parties won more than 50% of the popular vote in Italy's election which could mean fiscal policy is looser, necessary reforms are shelved and banks' balance sheets remain burdened by non-performing loans	Beijing's initial response to U.S. tariffs was relatively measured, indicating potential tariffs on about $3 billion of U.S. imports A trade war involving China could affect Asia-Pacific business activity and growth, given regional supply chains and China's economic size China's debt overhang is not going away but the authorities' increased focus on reducing financial risks should see improvements in debt leverage	Political risk is increasing in Latin America as elections in Brazil, Colombia, Mexico approach The U.S. is retracted its contentious demand for auto imports from Canada, Mexico to contain 50% U.S. content and this could break the impasse in the stalled NAFTA renegotiation
Macro-economic conditions	U.S. real GDP growth of 2.9% in 2018 and 2.6% for 2019, helped by a boost from the tax package, increased government spending U.S. tariffs announced so far will likely have minimal direct impact besides marginally boosting inflation and creating headwinds for productivity growth Canada real GDP growth of about 2% through 2020 supported by improving trade and investment	Recent surveys suggest Eurozone GDP growth might have peaked A strong euro is pressuring European exporter's competitiveness and making the ECB's task of generating higher headline inflation more difficult	China recently released its growth target of "around 6.5%" this year; no surprises there Asia-Pacific growth is mixed -- India (strong, led by investment), Australia (mediocre, held back by soft investment, net exports), while the Tiger economies are seeing a lift from exports and industrial production	Domestic consumption and an advantageous global economy is supporting upward revision to Latin America GDP growth assumptions Brazil's Improving labor market conditions, benign inflationary pressures, and lower domestic interest rates will continue to benefit household spending
Financing conditions	The Fed's policy normalization path remains a potential trigger for volatility, but a flat yield curve is supporting steady financing conditions Covenant-lite features for leveraged loans are a concern but distress signals are scarce	Financing conditions remain highly accommodative as the Eurozone credit cycle is running several years behind the U.S. The ECB unlikely to raise their key marginal lending facility rate until mid-2019 Demand not supply factors are expected to weigh on private credit growth in the U.K.	Despite marginally tighter credit standards in emerging Asia, we expect monetary policy settings will overall stay accommodative Chinese authorities have selectively raised rates and restricted certain forms of lending	Elections may bring some volatility to debt markets and perhaps higher funding costs and disrupt otherwise favorable financing conditions
Sector trends	Production gains for U.S. steel, aluminum producers will depend on the number of countries exempted from U.S. tariffs The import dependent U.S. apparel industry could be hurt if China imposes retaliatory tariffs Gains in U.S. growth have delivered fiscal relief to state budgets but a rise in global protectionism could squeeze state tax revenues	Greater shareholder friendly activity, including M&A, limits upwards rating migration for nonfinancial corporate issuers Regulators are still working to reinforce the strength of banks' balance sheets over the cycle and ensuring appropriate provisioning of banks' non-performing exposures A rising rate environment could see life insurers prioritize the liability side of their balance sheets through pricing, fee-based and insurance risk driven products plus liability management	Japan's auto makers are growing steadily but competition in China is stiff The building materials industry is enjoying steady prices with infrastructure investments remaining a key driver Higher commodity prices are supporting credit quality for Asia-Pacific metals and mining, and oil and gas producers Bank ratings pressures to persist with negative trends still for Japan, Australia and New Zealand	Political risk is playing a bigger role than economic risks in our assessment sovereign ratings in the region Tight finances are likely to remain among Latin American LRGs during 2018, with only a few local governments with real capacity to increase capital expenditures beyond the basic maintenance needs Inflation to continue pressuring margins of Argentine rated corporations, but business conditions are turning more favorable across the board

Our regional Credit Conditions Committees continue to monitor a number of risks. With this update we moved the risk trend to increasing from stable after recent developments on tariffs and trade trends. We also moved the risk trend on geopolitical developments back to stable from increasing. After a period of highly charged rhetoric and deteriorating relations with North Korea, proposed U.S.-North Korea talks are an encouraging development. On the other hand, North Korea's persistent defiance on denuclearization remains a challenge to a peace deal. Moreover the deteriorating state of Russian relations with the West and the possibility of the U.S. refusing to extend the Iran nuclear accord is a concern for stability so our Credit Conditions Committees did not change their view that the risk level relating to geopolitical tensions remains high.

Trade And Tariffs

In North America, trade tensions resulting from new U.S. tariffs, heightened financial market volatility, and rising interest rates pose the greatest threats to the prolonged period of favorable credit conditions—but the prevailing low risk of recession in the region may help extend this benign borrowing environment.

The tariffs announced so far by the Trump Administration will likely have minimal direct macroeconomic effects—boosting consumer price inflation only marginally and weighing a bit on already sluggish productivity growth. The greater risk is that some of the U.S.'s trade partners will retaliate and spark an all-out trade war that eventually hurts exporters—not only in the world's biggest economy but around the globe (see "Global Trade At A Crossroads: If U.S. Tariffs Trigger A Trade War With China, Corporate Credit Will Suffer," published March 23 on RatingsDirect).

We see the risk of an all-out trade war that eventually hurts exporters around the globe.

After the president signed off on tariffs of 25% on steel and 10% on aluminum from all countries except Canada and Mexico (later exempting the E.U., Australia, Argentina, Brazil, and South Korea) he imposed broad tariffs on imports from China that could affect as much as $60 billion of goods each year—and announced planned restrictions on Chinese investment in American technology companies.

This followed his directive last year under Section 301 of the Trade Act of 1974 to launch an investigation into China's alleged theft of U.S. intellectual property. Section 301, which allows the president to act without consulting the World Trade Organization (WTO), is rarely used and is considered by some to be an act of aggression given the U.S.'s commitment to resolve disputes through WTO settlement mechanisms. China became a member of the WTO in 2001, and since that time, U.S. imports from that country have more than quadrupled, while American goods sold there have surged sixfold – even though the U.S. is still running a large trade deficit with China.

Already, Chinese officials have said the country will impose retaliatory tariffs on $3 billion of U.S. products, including pork, recyclable aluminum, fruit/nuts, wine, and steel pipes. To understand the potential economic effects of these tit-for-tat moves, consider that when the Obama Administration increased tariffs on tires imported from China in 2009, the Chinese government answered with significant tariffs on U.S. poultry, which, according to a study at the Peterson Institute for International Economics, shaved $1 billion from U.S. poultry exports.

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Clearly, the biggest effects outside the U.S. would be felt in President Trump's target: China, which sends about 19% of its exports to the U.S. (see chart 1). Consumer electronics (under machinery and electrical goods) accounted for half of China's trade surplus with the U.S., while China is a net importer from the U.S. of soybeans and aerospace goods.

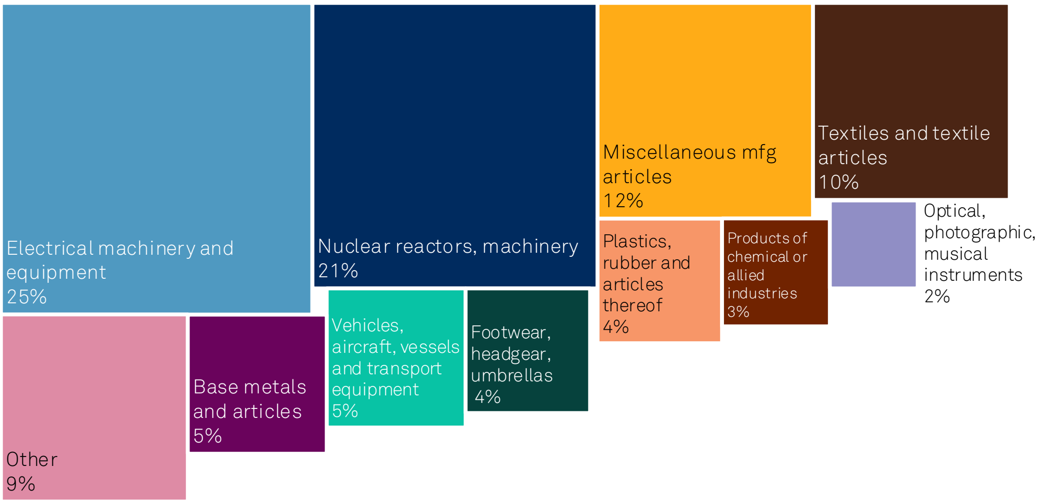
Nor is Latin America immune from increasingly protectionist measures from the U.S. Although Mexico is exempt from U.S. steel and aluminum tariffs, the increased possibility for additional tariffs, trade skirmishes, and retaliation from other countries could derail global growth, which could hurt Latin America's credit conditions.

Chart 1

Exports to the U.S. account for 19% of China's total exports

Value of China's total exports to the U.S.: $433,146.48* (USD mil.)

Breakdown of total exports to U.S. by categories



*2017 figures. Sources: CEIC, S&P Global Ratings.

This comes as representatives from the U.S., Canada, and Mexico continue to renegotiate the North American Free Trade Agreement (NAFTA). Since the agreement took effect in 1994, trade among the member countries has tripled, to more than $1.1 trillion last year, and cross-border investment has grown significantly, to $731.3 billion, from $126.8 billion in 1992. If President Trump were to follow through on his promise to tear up the deal, the move could trim billions of dollars a year from U.S. GDP growth and resound through the region (see "Killing NAFTA Would Hurt The U.S. Economy And American Manufacturers," published Nov. 8, 2017).

Geopolitical Tensions

In addition to the challenge to the global world trade order, there is heightened geopolitical risk arising from President Trump's nomination of Mike Pompeo as U.S. Secretary of State and appointment of John Bolton as National Security Advisor. Both Pompeo and Bolton have pushed for regime change in North Korea and Iran. This could raise the prospect of a pre-emptive strike on the former and the U.S pulling out of its nuclear accord with the latter.

At the same time, Russia has vowed to answer in kind to the decisions by the U.S. and 14 European allies to expel a number of Russian diplomats following a nerve-agent attack on a former spy in the U.K., which is alleged to have been ordered by the Kremlin.

On the bright side, tensions with North Korea appear to have abated somewhat after a show of north-south unity at the Winter Olympics, and a visit of South Korean officials to the north, leading to an invitation for President Trump to meet Kim Jong-un.

Political risk, too, is increasing in Latin America as elections in key countries approach. Uncertainty around voting results in Brazil, Colombia, and Mexico is counterbalancing the positive effects of global growth and capital flows to the region. We believe investors are delaying their decisions and waiting for more clarity about the policies the new administrations will follow—and the rise of anti-establishment could make for greater policy uncertainty and make it difficult to pass relevant reforms.

On the regional front, Brexit remains a live issue, although following the political agreement reached over transition, the risk of a disorderly exit in March 2019 has been reduced. While it's encouraging that negotiations on the nature of the future relationship encompassing trade, security, and defense can proceed, we don't underestimate the remaining challenges given the complexity of the issues. As such, we continue to see the risk level as high although the immediate pressures appear to have diminished for now. On another front, eurosceptic parties won more than 50% of the popular vote in Italy's election, which could make for looser fiscal policy, and mean that necessary reforms are shelved and banks' balance sheets remain burdened by non-performing loans.

Macroeconomic Conditions

North America

In the U.S., sustained—if unspectacular—economic growth prevails. The $1.5 trillion tax package that the president signed into law late last year, together with the $1.3 trillion spending bill that would fund the government through September, has given the world's biggest economy a near-term boost, almost ensuring that this expansion will be the longest in American history.

S&P Global expects U.S. real GDP growth of 2.9% this year, helped by a boost from the tax reform and federal spending.

S&P Global now expects U.S. real GDP growth of 2.9% this year, helped by a boost from the tax package of close to 0.3 percentage point both this year and the next. Additionally, increased government spending is likely to add 0.3 and 0.4 percentage point to growth in 2018 and 2019, respectively. Our qualitative assessment, which recognizes hard-to-measure policy mistakes, remains at 10%-15%.

S&P Global Ratings' economists now expect the Federal Reserve to raise the benchmark federal funds rate four times this year, after last week's quarter-percentage-point hike to range of 1.50-1.75%—the first under new central bank Chair Jerome Powell.

Asia-Pacific

In the Asia-Pacific region, 2017 was another year of solid growth, and we see no big changes in our view of the region. China released a growth target of "around 6.5%" this year—which comes as no surprise. We expect external demand to be reasonably solid as the synchronized global rebound continues. For now, it's all about U.S. trade policy and the reaction of major trading partners, as a trade war would weigh on confidence, spending, and growth.

EMEA

In the euro zone, GDP grew 0.6% on the fourth quarter, contributing to full-year economic expansion of 2.5%—the strongest since 2007. Further gains in investment spending, and a positive contribution from net trade, along with an increase in consumer spending all underpinned the expansion in the final three months of the year. Moreover, export growth reached roughly 2% in the quarter, demonstrating that eurozone companies have taken stock of the acceleration in world trade and dynamic domestic demand by ramping up investment.

Looking forward, we expect eurozone GDP growth to continue at about the same pace for the first quarter as the region enters into a more mature phase of its expansion, with the output gap closing rapidly. The moderation visible in some manufacturing surveys suggests that tailwinds from global trade in the industrial sector have stabilized, yet buoyant services surveys continue to point to a robust domestic demand, boosting employment.

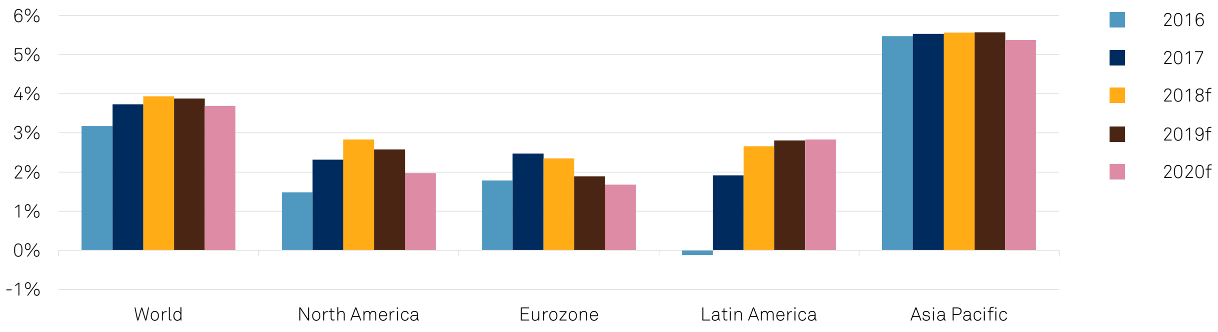
Latin America

We've raised our forecast for most major Latin-American economies.

Elsewhere, we're marginally increasing our 2018 GDP forecast for most of the major Latin-American economies, solidifying our expectations of stronger growth this year. We now expect the region's GDP to grow around 2.2%, up from 1.1% last year. Economic activity across major global economies has grown more than we expected in recent months, which means that the positive effects from outside the region will be greater than we previously anticipated. Stronger global demand has also improved the outlook for major commodity prices, which will help investments and exports in Latin America.

Chart 2

Regional Real GDP Growth



f--Forecast. Source: S&P Global Ratings.

Financing Conditions

North America

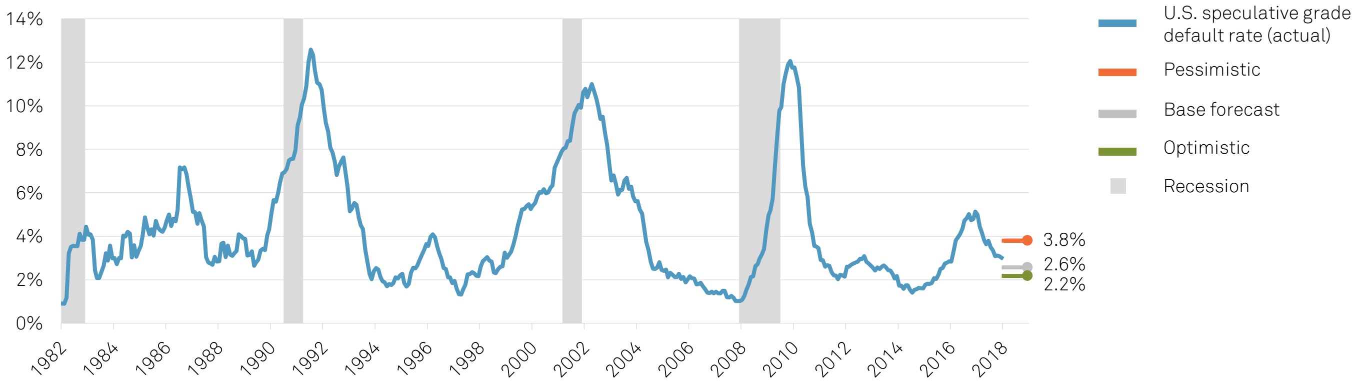
In the U.S., 2018 began with financial-market volatility at a level not seen in years, with a jump in Treasury yields alongside a correction in benchmark equity indexes. The CBOE Volatility Index (VIX) closed at 37.3 on Feb. 5, its highest closing level since Aug. 24, 2015, and its second-highest intraday level (50.3) the next day. Fixed-income markets also wobbled, with the yields on the 10-year Treasury closed at 2.9% on Feb. 22, from 2.4% at the start of the year.

The Fed's plan to reduce its balance sheet while raising key interest rates is a top concern for near-term U.S. financing conditions and debt issuance. In announcing last week's rate hike, the Fed signaled two more for this year, but the so-called "dot plot" of the projections of the rate-setting Federal Open Market Committee (FOMC) showed that members were close to that projection being four increases in 2018. And policy makers also raised the forecasts for hikes in 2019 and 2020, citing a stronger outlook on the economy.

While we expect financing conditions to become slightly tighter as market volatility generally increases (separate from any short-term burst or selloffs seen thus far), conditions for now remain broadly supportive. 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 assumptions, and we believe U.S. corporate borrowers will be able to manage their maturities in the near-term. S&P Global Fixed Income Research forecasts the U.S. trailing 12-month spec-grade default rate will fall to 2.6% by year-end, from 3% in December 2017 (see Chart 3).

Chart 3

U.S. Trailing 12-Month Speculative Grade Default Rate And December 2018 Forecast



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

Asia-Pacific

In Asia-Pacific, on the other hand, defaults may soon increase. Chinese companies remain big borrowers, but are taking steps to gradually lower their financial leverage. While we expect further modest deleveraging into the second quarter, we also think authorities will allow more defaults of the country's riskiest borrowers—which isn't necessarily a bad sign. Regulators are taking advantage of continued economic reflation to shut down backdoor funding channels and hold the more heavily indebted state-owned enterprises to more disciplined financial standards (see "Rising Profits Won't Rescue China's Riskiest Companies As Liquidity Tightens," published Jan. 29).

EMEA

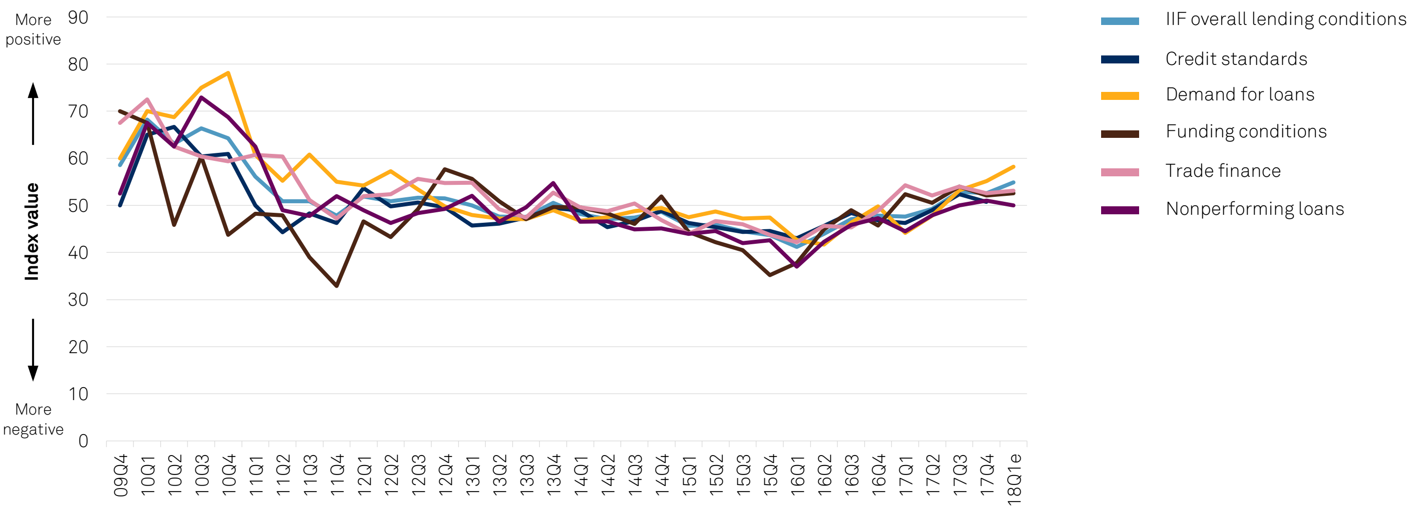
At the same time, the eurozone credit cycle is running several years behind the U.S.'s, reflecting the later recovery. But similar to the U.S., eurozone inflation has shown few signs of rising, as wage growth has remained constrained. Our current interpretation of forward guidance from the European Central Bank (ECB) is that policy makers are unlikely to raise their key marginal lending facility rate until the middle of next year. Indeed, there is a risk that further euro strengthening, by damping inflation and growth, could mean that the ECB delays the turn in the rate cycle in the eurozone.

Latin America

Meanwhile, global financial conditions remain beneficial for Latin America, although the most recent Institute of International Finance's (IIF) Lending Survey showed a marginal decline in a few areas (see Chart 4).

Chart 4

Institute Of International Finance Survey Of Lending, Latin America



e--Estimate. Data as of Dec. 31, 2017. Source: IIF.

Survey results are generally considered favorable if greater than 50% and unfavorable if lower than 50%. Funding conditions and trade finance metrics declined slightly to 52% and 53%, respectively, as did credit standards to 51%. Demand for loans and nonperforming loans (NPLs; in this case the absence of) improved to 55% and 51%, respectively. Overall, the index remained flat at 53%.

Still-copious global liquidity and a strong appetite for high-risk assets is attracting capital into the region, resulting in stable-to-stronger exchange rates and narrower fixed income spreads, despite the substantial domestic political risk. The continued gradual monetary tightening in developed economies and the need for higher yields support capital flows to the region.

Related Reading

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We recently published our regional review of meetings held in March 2018:

- North America March 2018--Trade Tensions, Market Swings Pose Risks To Benign Conditions
- EMEA March 2018--Trade And Market Volatility Threaten To Overshadow Brexit
- Latin America March 2018--Political Risk May Dampen The Impact Of A Global Economic Upswing
- Asia-Pacific March 2018--Risk Of China-U.S. Trade War Escalates