

Credit Conditions North America:

Trade Tensions Cloud The Outlook

June 27, 2019

Key Takeaways

- **Overall:** Fears are growing that economic conditions in the U.S. have worsened, and the lending backdrop has become cloudier. Still, the expansion in the world's biggest economy is set to reach record length, and we see little chance of recession in the next 12 months.
- **What's changed:** Financial market volatility has increased and spreads have widened for borrowers up and down the ratings ladder.
- **Risks and imbalances:** 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.
- **Financing conditions:** Financing conditions remain broadly supportive of continued borrowing; however, they are not as rosy as at the same time last year or the year before. Global risks are growing, and it is likely markets are over-optimistic.
- **Macroeconomic conditions:** Of the 10 leading indicators of near-term U.S. economic growth we track in our monthly Business Cycle Barometer, five are positive, three neutral, and two negative.
- **Sector themes:** For nonfinancial corporates, credit risk has increased, with downgrades, defaults, and the negative ratings bias up slightly. For U.S. banks, we expect a sharp decline in earnings growth this year.

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(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 June 24, 2019.)

Escalating trade tensions have heightened fears that economic conditions in the U.S. have worsened, with signs that businesses are curbing spending and sentiment surveys suggesting investors are moving toward more defensive asset allocations. While most indicators of financing conditions remain largely supportive, deteriorating economic data and heightened global political tensions has led to concerns that credit conditions will become more difficult.

Financing conditions. Despite a period of financial market volatility in May, financing conditions have improved substantively in the first half of the year with BBB corporate yields falling by over 100 basis points and spreads tightening by around 40 basis points. Year over year comparisons are less favorable and leverage loan issuance has declined. Political tensions between the U.S. and Iran, and the trade dispute with China pose the most immediate threat of risk premiums rising.

Economic conditions. Of the 10 leading indicators of near-term U.S. economic growth we track in our monthly Business Cycle Barometer, five are positive, three neutral, and two negative. Deceptively strong first-quarter U.S. GDP growth was largely driven by an inventory build-up and net export strength as businesses tried to get ahead of protectionist trade actions. A closer look shows the economy is cooling. That said, the expansion in the world's biggest economy is about to reach record length, and we see little chance of recession in the next 12 months.

Sector trends. For nonfinancial corporates, credit risk has increased, with downgrades, defaults, and the negative ratings bias up slightly. For U.S. banks, we expect a sharp decline in earnings growth this year, to single-digits, after a year in which they benefited from reduced tax rates and higher interest rates. With the pause in the Federal Reserve's monetary tightening (and, in fact, markets now pricing in a rate cut) fewer banks are likely to report higher net interest margins.

Table 1

Top North-America Risks

Geopolitical and trade disputes cloud world growth

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

The world’s multilateral trade framework has been shaken by key-country unilateral policy changes. U.S.-China friction has broadened from tariffs to technology. Middle East tensions pose a risk to energy markets. Such prolonged global tensions impact investment sentiment and long-term growth. The U.S. removal of tariffs on steel and aluminum imports from Mexico and Canada, and Mexico’s ratification of the U.S.-Mexico-Canada Agreement (USMCA) eases some uncertainty around trade relations in the region. The Canadian government introduced implementing legislation, but it plans to follow the U.S. ratification process closely—and any amendments proposed by U.S. Congress—before putting the deal to a final vote in Canada’s parliament.

Mature credit cycle and volatile liquidity

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

The Fed’s dovish policy bias is supporting liquidity and extending a mature credit cycle. Still, the build-up in nonfinancial corporate debt and leveraged lending in the U.S. and elsewhere is a source of instability. Risk aversion and measures of financial stress are inching up again after easing from 2018’s extreme levels. Demand for safe assets is rising and wider credit spreads are crimping financing conditions, but volatility remains relatively subdued compared with late 2018 levels, which severely restricted borrowers’ access to capital markets’ sources of funding.

Cybersecurity threats to business activity

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

Increasing technological dependency and global interconnectedness means cyber risk poses a systemic threat and significant single entity risk. Companies face the risk of criminal, proxy, and direct state-sponsored cyber-attacks.

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

The cumulative impact of rising interest rates since mid-2017 plus macroprudential policy tightening—notably, tougher federal government mortgage qualification rules for homebuyers—are contributing to a faster deceleration in house prices for Canada, and household credit growth is slowing more quickly versus other advanced economies. Although consumer debt service burdens are easing with the slower accumulation in new debt, and a pick-up in income growth is also supporting debt servicing capacity, elevated house price-to-income multiples and stretched housing affordability remain a threat to financial stability. The Bank of Canada’s recent shift to a dovish policy will support steady debt-service ratios for consumers.

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 12 months.

Regional credit conditions

What's changed?

Escalating trade tensions have heightened fears that economic conditions in the U.S. have worsened, with signs that businesses are curbing spending and investor skittishness feeding financial market unrest. Against this backdrop, it's likely the Fed will not only pause in its monetary-policy tightening cycle, but lower benchmark borrowing costs. While most indicators of financing conditions remain largely supportive, the lending backdrop has become cloudier, hinting at a slight turn in the credit cycle.

Assessment of key risks

The top threat to what has been a prolonged benign run of credit condition in the region is the uncertainty around trade—in particular, the Trump Administration's tariff war with China. While the dispute will likely have minimal direct macroeconomic effects on either country in the near future, the longer-term consequences for global supply chains, U.S. business sentiment, and consumers' purchasing power are growing. We expect the U.S. 25% tariffs on Chinese imports, combined with reciprocal retaliation from China, will directly shave off only about 30 basis points (bps) from U.S. growth in the next 12 months—perhaps a bit more in secondary effects such as tighter financial conditions and reduced business investment.

Trade: 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. 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, and domestically produced goods could cost more if companies reinvesting in onshore production displace consumer access to cheaper imports. Lower trade that reduces competition and undermines productivity could limit short-term employment gains from reshoring production.

Debt: U.S. nonfinancial corporate debt is perched at a new high of \$9 trillion, or 45% of GDP, after a lengthy period of uninterrupted credit growth stretching back to 2012. Declining average credit quality points to greater sensitivity to rising borrowing costs. The pick-up in leveraged lending and speculative-grade bond issuance is a vulnerability that could amplify credit stresses if investor risk-aversion tightens financing conditions, or reduces market access for borrowers.

Interest Rates: It now appears that a meaningful slowdown in domestic demand from the U.S.' various trade disputes will lead the Fed to lower its benchmark interest rate. Consistent with our growth, unemployment, and inflation forecasts, S&P Global Economics expects the U.S. central bank to cut the federal funds rate 25 bps, possibly as soon as its September policy-setting meeting—with last year's run of four rate hikes perhaps having marked the end of the tightening cycle.

Canada Housing: Household credit growth is slowing in response to interest rate rises from the Bank of Canada and new mortgage lending guidelines that introduced stress test for homebuyers. Still, with elevated price-to-income multiples squeezing home affordability and households having accumulated a record C\$2.1 trillion in credit market debt, housing market imbalances remain a key vulnerability for Canada's economy.

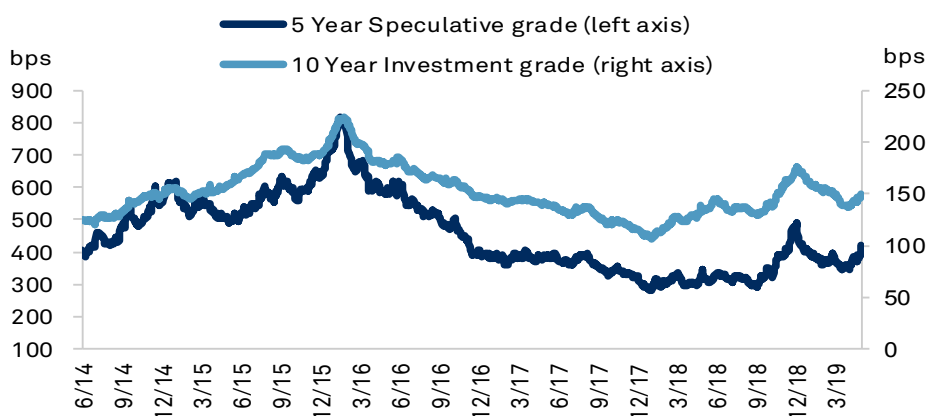
Tariffs on Chinese imports, combined with retaliation from China, could trim 30 bps from U.S. growth in the next 12 months

Financing conditions

Most indicators of U.S. financing conditions have remained largely supportive in the past few months. That said, the lending backdrop isn't as rosy as it was even a year ago, potentially indicating an initial—albeit slight—turn in the credit cycle. Geopolitical stressors refuse to let up, and market volatility noticeably increased in May, alongside plummeting Treasury yields. Going into the month, the 10-year note yield was 2.5%; by the end of May it had fallen to 2.14%—and it was 2.09% as of June 14. This led to a rise in corporate bond spreads for both investment-grade and spec-grade borrowers; hitting 150 bps and 421 bps, respectively, at month-end (see Chart 1). And with the expectation for more rate cuts by the Fed, leveraged loan issuance has been declining.

Chart 1

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



Data as of May 31, 2019.

Source: S&P Global Fixed Income Research

Certainly, the Fed's halt to rate increases and the slowing of its balance-sheet reduction will support lending conditions going forward. But those tailwinds will likely clash with slowing economic growth, as well as a deteriorating global backdrop.

Tensions have developed between the U.S. and Iran over suspected Iranian attacks on oil tankers, and Iran's apparent downing of a U.S. drone—followed by reports that the White House ordered, then called off, retaliatory military strikes. While oil prices rose after the tanker attacks, it doesn't seem we'll see a sharp spike in the near-term. But if this situation worsens, it could result in higher oil prices and adverse market conditions at a time when the U.S. economy is on less-sure footing.

With geopolitical headwinds growing, the drop in Treasury yields reflects a flight to safety by investors. Markets have increased their expectations for rate cuts by the Fed this year. This makes sense, as only the yield on the 30-year Treasury was above the effective fed funds rate of 2.39% at the end of May, with yields on all other Treasuries (from 1-month to 20 years) below this level.

Despite the widening in corporate spreads in May, we estimate the spec-grade spread should have finished the month nearly 100 bps wider, based on various economic and financial indicators. The implied spread has exceeded the actual in six of the past eight months. This could imply that financial markets are overly optimistic in the face of sustained pressures. That said, the upcoming maturity profile for U.S. spec-grade issuers appears largely manageable (see chart 2). Issuers have been paying down upcoming debt at a steady pace, and after a rough patch at the start of the year, issuance has remained well ahead of maturities over the next 12 months.

Global Fixed Income Research projects the spec-grade default rate to come in at 2.7% through March 2020 (see chart 3). This is up from a very low base of 2.1% at the end of March of this year, but still lower than the long-term average of 4.2%. The expected slowdown in corporate profits has arrived, and global risks are rising. This is offset somewhat by an economy that continues to grow, and expectations that the Fed will lower rates this year. By sector, we still expect energy and

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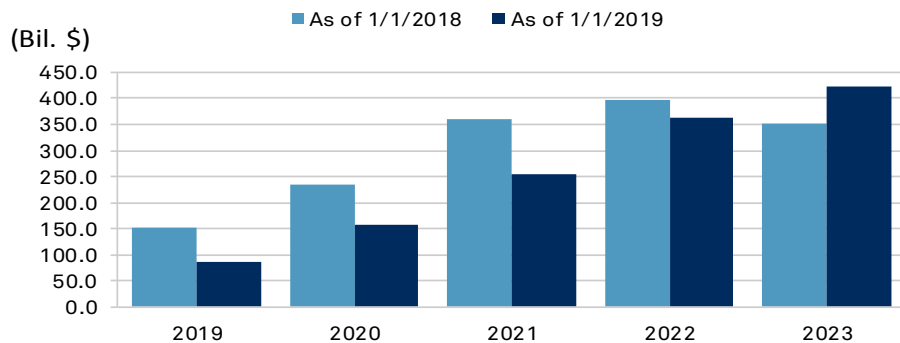
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consumer-reliant sectors (such as retailers and consumer products) to lead in terms of defaults, given their ongoing external stressors and structural changes.

Chart 2

U.S. Speculative-Grade Nonfinancial Corporate Maturity Wall

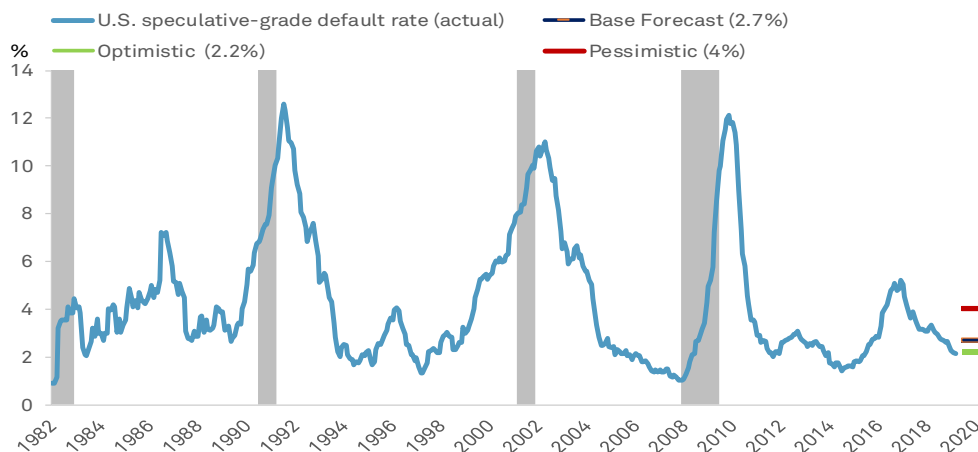


Note: Includes bonds, loans, and revolving credit facilities that are rated by S&P Global Ratings on the respective report date. Foreign currencies are converted to USD on the respective report period date.

Source: S&P Global Fixed Income Research

Chart 3

U.S. Trailing-12-Month Speculative-Grade Default Rate And March 2020 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®

Municipals

For U.S. municipal debt, issuance has yet to return to its pre-tax reform pace, and we think it's unlikely to do so. May's issuance fell from a year earlier, bringing this year's total slightly below a light 2018, and was the second straight month of declines. Through March, issuance was 19% higher than in 2018, but the past two months have erased that. On the other hand, low volume and a healthy appetite for munis have pushed yields down and boosted returns in all sectors.

The exclusion of refunding bonds from tax exemption under last year's legislation drastically changed muni issuance, and the awaited rebound to normal hasn't happened. The issuance of new-money bonds last year was the highest since 2010, which may indicate greater demand for investment in roads, bridges, schools, and other assets funded by municipal debt. But even with an increase in new-money proceeds, overall volume fell 24%. Without a change to tax law or a significant infrastructure initiative at the federal level, state and local issuance will likely settle into a lower baseline than in the past two decades.

Macroeconomic developments and assumptions

(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: Of the 10 leading indicators of near-term U.S. economic growth that S&P Global Ratings' economics team looks at in our monthly Business Cycle Barometer, five are positive, three neutral, and two negative. Given the 10-year/3-month yield curve has been inverted since May, the "term spread" indicator has likely moved to negative from neutral. Escalating trade tensions have heightened fears that economic conditions have worsened, with signs that businesses have tightened their purse-strings and investor sentiment deteriorating. Deceptively strong first-quarter GDP growth was largely driven by an inventory build-up and net export strength as businesses tried to get ahead of protectionist trade actions.

Real first-quarter GDP growth was 3.2% year-over-year—the fastest pace since early 2015—but a closer look shows the economy is cooling. Consumer spending rose just 1.3%, the slowest in a year, while business investment weakened further, and residential investment fell for the fifth straight quarter. Still, we're set to mark the date that the U.S. economic expansion becomes the longest in the country's history, passing the 10-year milestone next month. How long it lasts remains to be seen, but it has been a remarkable run—one that we think will continue for at least the next 12 months.

Outlook: S&P Global Ratings now forecasts full-year U.S. GDP growth of just 2.5% this year and 1.8% next year, followed by average annual expansion of 1.8% for 2021-2023. We expect unemployment to drift higher, after reaching a low of about 3.4% in the second half of this year, with core consumer price inflation rising to 2.0% by next year. We expect weakening growth momentum and a benign inflation outlook will now prompt the Federal Reserve to lower interest rates—perhaps as soon as September, with a cut of 25 bps. Depending on the data, we see policymakers then remaining on the sidelines through next year.

Risks: The escalation of trade disputes remains the largest downside risk to our forecast. Increased tariffs have yet to manifest as steep increases in overall consumer goods prices (although prices on individual products such as washing machines, for example, did go up); however, the potential is there. While the U.S.-China dispute will likely have minimal direct macroeconomic effects on either country in the near future, the longer-term consequences for global supply chains, U.S. business sentiment, and consumers' purchasing power are growing.

Canada

State of Play: Real GDP increased at an annual rate of just 0.4% in the first quarter, after a similarly disappointing 0.3% in the final quarter of 2018. Although steadier commodity markets and a rebound in oil prices improved Canada's terms of trade, export losses flowed from oil production cuts in Alberta and output declines in Canada's auto industry. On the other hand, domestic spending rebounded from back-to-back quarterly declines in the second half of last year, advancing 3.4% in the first quarter and moving above the estimated range for potential GDP growth (1.5%-2.0%). Consumers spent more on discretionary items such as autos, furniture, and appliances, while businesses purchased new machinery and equipment. However, residential investment continued to slow, with weaker housing starts mirroring declines in home sales and a deceleration in home prices. Job availability is still improving, and in May, consumers' purchasing power was bolstered by a dip in unemployment, to a four-decade low of 5.4%. Wage growth is running ahead of inflation, and this is spurring consumer spending.

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We now forecast full-year U.S. GDP growth of just 2.5% this year and 1.8% next year

Outlook: We lowered our full-year estimate for real GDP growth to 1.2%, from 1.5%, following the first quarter's subpar performance. Although global trade frictions and the possibility of an investment-led slowdown remain a threat, we see the recovery in domestic spending positioning Canada for a return to trend growth closer to 2% in 2020 and 2021.

The Bank of Canada's preferred measures of core inflation have moved within a 1.8%-2.3% range, after reaching as low as 0.8% in 2017. The first-quarter recovery in domestic spending should keep inflation close to its 2% target, so it seems there's little reason for the central bank to change its policy rate. The last move in October of last year was a 25 bps hike, to 1.75%—where we expect the rate to stay through the remainder of this year and next.

Measures of financial leverage have begun to stabilize with the pickup in household incomes, and debt service ratios are steadier, with the BoC's shift to accommodative policy. Still, debt affordability remains stretched, and heavy consumer debt burdens will likely limit growth in consumer spending.

Canada is moving closer to ratifying the USMCA, and the U.S.'s removal of tariffs on Canadian steel and aluminium are easing uncertainty around Canada's relations with its largest trading partner. This could lift capital spending and we see a firmer profile emerge for business fixed investment.

Risks: At 1.75%, the BoC's policy rate remains below its neutral range (2.25%-3.25%), which seems appropriate against the backdrop of slower international trade, as well as escalating geopolitical and trade disputes, which continue to weigh on business sentiment and investment intentions. A weaker profile for investment could also emerge if rising tensions in the Middle East and volatile commodity markets deteriorate Canada's terms of trade.

We've lowered our full-year estimate for Canada's GDP growth to 1.2%, from 1.5%

Non-Financial Corporates

- We expect ratings to be broadly stable, with credit risk focused on consumer products, retail, pharmaceutical, and health care services.
- The negative effects of the U.S.-China dispute have been modest so far, but we see more harmful credit effects if tensions ratchet higher.
- An economic/credit cycle downturn, asset market/risk repricing, geopolitics and escalation in trade conflicts continue to be the main risks to corporate credit conditions.

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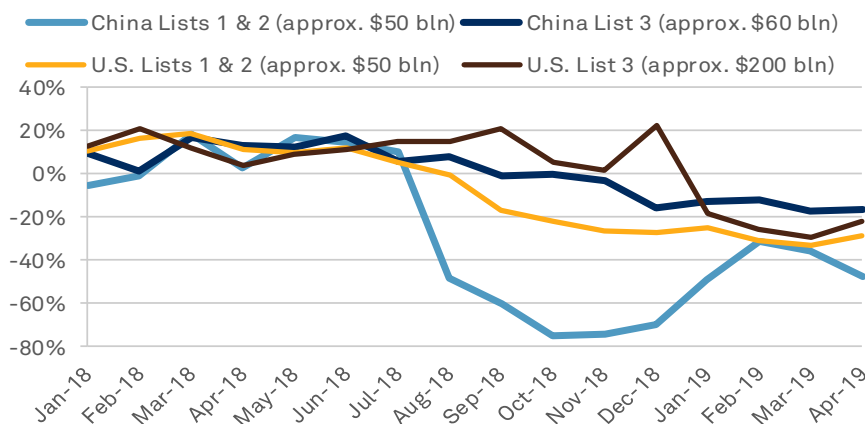
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What's changed?

Trade tensions escalated further. The U.S. announced its intention to place tariffs of 25% on the remaining imports (see chart 4) from China that haven't yet been subject to levies—about \$300 billion worth, including smartphones, laptops, apparel, footwear, and toys, that would directly affect consumers. The U.S. has also imposed an export ban on tech giant Huawei, prompting China to announce its own “blacklist” and hint at an export ban of rare-earth minerals. These actions could escalate non-tariff measures and retaliation. The U.S. also threatened new tariffs on Mexico's products (shelved based on progress in addressing immigration), but auto tariffs remain on the table.

Chart 4

U.S. And China's Imports Of Tariffed Products (year-over-year change)



Source: Panjiva

Credit risk has increased, with downgrades, defaults, and the negative bias up slightly. In terms of our sector outlooks, we lowered consumer durables to ‘negative’ and forest products to ‘stable to negative’. Both sectors are confronting weaker demand in the U.S. and China and softness in the U.S. housing market. The consumer durables sector continues to be pressured by rising labor and other input costs, including the impact of steel and aluminum tariffs.

Key assumptions

We continue to expect growth in the U.S economy to decelerate without slipping into recession. With the Fed's and other central banks' shift to a more dovish stance, we expect continued supportive financing conditions.

Key risks

We see a downturn in the economy/credit cycle, asset market/risk repricing, geopolitical turmoil and escalation in trade conflicts as the main risks. The U.S.-China tariffs will have minimal direct impact, but if the dispute begins to erode confidence and tighten financial conditions, the negative

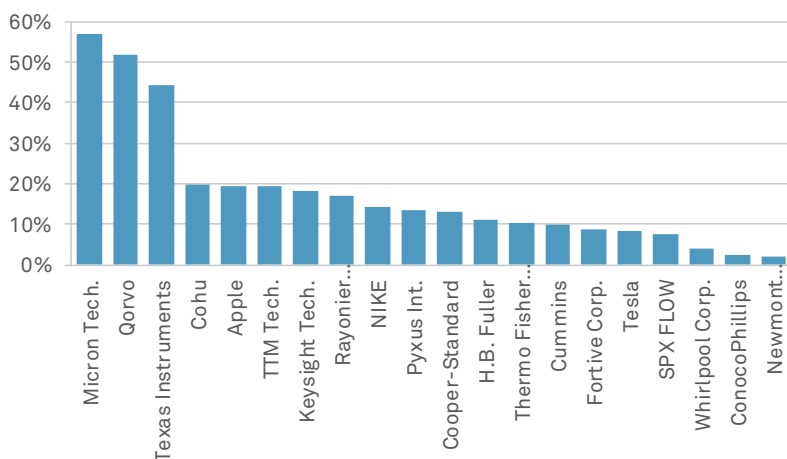
economic and credit effects will be more damaging. The decline in average credit quality and the growth in leveraged loans and spec-grade bonds outstanding could amplify credit stresses, resulting in higher defaults in a protracted capital market dislocation and/or credit downturn.

What to look for in the next quarter

Although we see increased credit concerns, we expect ratings to be broadly stable. Credit risk remains focused on consumer products, retail, pharmaceuticals, and health care services. We expect headwinds for earnings and cash flow, given slower growth in the U.S. and weaker economies abroad, higher labor and input costs, and the dollar’s strength.

We see more downside risk in the subsequent rounds of U.S.-China escalation. Autos, capital goods, consumer products, retail, and technology could see more pressure (see chart 5). These sectors have either relatively high input-cost exposure to China, a limited ability to pass on costs to consumers, and/or more vulnerability to retaliation.

Chart 5
Share of Revenues from China



Source: S&P Global Market Intelligence. This is a select list of companies that published China revenue shares in their latest 10-K filing (as of 20 June 2019).

The speculative-grade maturity wall continues to be pushed out, limiting refinancing risk. Still, lower-rated issuers face funding risk in a more volatile or less borrower-friendly credit environment. Some retail, oil and gas, health care, and downstream metals companies have significant amounts of spec-grade debt coming due in the next couple of years. These approaching maturities, combined with a credit cycle downturn, could lead to defaults. In the retail sector, we see distressed exchanges and the potential for selective defaults in advance of maturities as an outstanding risk.

Financial Institutions

- Heightened trade disputes are raising private-sector uncertainty, slowing loan growth.
- Monetary policy tightening has stalled, flattening the yield curve and pressuring net-interest margins.
- Potential asset-quality weakening, in a downturn, seems most likely among highly leveraged corporate loans and commercial real estate in the U.S., and consumer loans in Canada.

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What's changed?

The most important changes for U.S. and Canadian financial institutions since the first quarter are an increase in private-sector uncertainty that is weakening consumption and business fixed investment—and, therefore, potential loan growth—and a more dovish outlook for the future path of interest rates, particularly in the U.S., which is weakening potential growth in net interest margins (NIMs). In the first quarter, we were still expecting the Fed to raise rates once, and possibly twice, this year; we now expect at least one rate cut.

Key assumptions

- We expect the Fed to cut its benchmark rate once, with the Bank of Canada on hold, and for full-year GDP growth to slow to about 2.5% and 1.2%, respectively, in those countries.
- U.S. loan growth is likely to continue at a low- to mid-single-digit pace.
- Credit losses have likely bottomed out and will gradually increase in 2019.
- The current expected credit loss (CECL) standard will be implemented on schedule (Jan. 1).
- The USMCA will remain on a slow path toward U.S. ratification.

Key risks

- A flattened yield curve will pressure bank profitability.
- Asset prices, already driven higher by (among other factors) an extended period of low interest rates, may rise further with the recent revision in the expected path of rates, risking a sharper eventual correction with associated capital-market volatility.
- Corporate credit quality, particularly in leveraged lending, could deteriorate after several years of significant loan growth.
- Credit quality may also worsen in auto, student, and CRE lending.
- In Canada, a sufficiently negative employment shock could trigger a substantial sudden decline in home prices, given still elevated (although moderating) prices. This could be accompanied by noticeably higher losses on consumer loans. We believe such a result unlikely outside a significant recession—which is not our base case.

What to look for in the next quarter

For U.S. banks, we expect single-digit earnings growth—down sharply from the rapid pace of last year, which benefited from reduced tax rates and higher interest rates.

NIMs will rise moderately on the back of modest loan growth, despite margin pressures. But with the pause in the Fed's monetary tightening, fewer banks are likely to report higher NIMs, and more will probably start showing declines. Fee income will depend on capital markets activity, market valuations, and mortgage volumes. Banks will continue to contain costs by consolidating branches, containing headcount, and growing digitization.

The Fed may finalize its 2018 proposal to tailor regulation for large banking organizations based on their risk profiles. It may also finalize a separate proposal to simplify its capital rules for large banks, most notably with the introduction of a stress capital buffer. Capital management at the global systemically important banks (GSIBs) will depend on the finalization of that proposal combined with the recent results of the Comprehensive Capital Analysis and Review (CCAR).

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For Canadian banks, we expect operating performance to continue to gradually strengthen, from domestic, U.S., and other international businesses, as large banks pursue scale- and strategy-enhancing acquisitions (at home and abroad) and continue to invest in efficiency-enhancing technology. Such improvement will be small and risk-prone, however, as Canadian banks face similar NIM pressure to their U.S. peers, and loan-growth opportunities in Canada will be more-constrained by weak growth in domestic credit demand. Because exports account for about one-third of Canada's GDP (substantially more than the equivalent measure for the U.S. and for most developed economies) sentiment is being hurt by the delay in U.S. ratification of the USMCA, in particular, and a generally less-certain outlook for global trade. Combined with an already-high household debt-to-income ratio, this will likely constrain Canadian demand for both household and corporate credit.

Insurance

- Our North American insurance sector outlooks reflect our expectations for limited change for the remainder of the year.
- Average financial strength for the portfolio is in upper half of the 'strong' ('A') category.
- Balance sheet strength continues to mitigate key risk factors.

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What's changed?

Ratings activity through May was strongly affirmation-oriented with very modest net downside movement linked to fundamental factors affecting three life/health borrowers. Overall, the average financial strength rating for the insurance portfolio continues to be just inside in the upper half of the strong ('A') category (see table 2).

Table 2

Sector	Average credit quality (financial strength rating)	% of ratings with stable outlook
Life	A+	83%
Health	A-	91%
Property / Casualty	A	79%
Global Reinsurers	A+	85%
Bond Insurers	AA	100%
Title Insurers	A	100%
Mortgage Insurers	BBB	67%

Source: S&P Global Ratings.

Key assumptions

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

Key risks

Factors related to pricing adequacy, profitability, portfolio yield, disciplined growth, regulation, policy risk, and slowing economic growth reflect areas of ongoing concern and analytical focus for the remainder of the year.

What to look for in the next quarter

Life insurers will likely see top-line growth this year, especially through group/voluntary insurance and pension risk-transfer businesses. Traditional life insurance will remain a low-single-digit growth line of business, whereas products that provide long-term care benefits within a life insurance or annuity chassis will continue to see higher growth. Annuities will remain in demand, driven by strong sales in indexed variable annuities and fixed-indexed annuities.

Block mergers and acquisitions (M&A) by traditional insurers and nontraditional capital investors will remain a key part of this market, whereas large-scale M&A remains less likely in the near term. Life insurers' spec-grade exposure remains contained, but insurers have increased their exposure to the 'BBB' category. With credit spreads tight, insurers have pushed their bond investments toward the lower end of investment-grade. From 2008-2018, 'BBB' category bonds held by life insurers have increased about 75%, well outpacing the 35% growth in their overall bond portfolios.

For health insurers, political/regulatory risks are emerging ahead of the 2020 elections. Multiple Medicare-For-All proposals have been floated that incorporate varying levels of government involvement, but we see a partial-to-complete restructuring of the industry as a low-probability/high-risk issue. The federal government's proposal to remove drug rebates in the Medicare/Medicaid markets is becoming increasingly unlikely for 2020.

We see the industry proactively restructuring itself through technology/service investments and M&A to stay ahead of competitive threats. We believe the CVS Health/Aetna and Cigna/Express Scripts mergers could be transformative, but they face near-term integration and leverage risks.

The U.S. property/casualty (P/C) sector has enjoyed a build-up of excess capital, attributable mainly to good earnings, dwindling share buybacks, and asset appreciation. The sector's capital helps to buffer adversity, including elevated catastrophe activity in the past two years and higher attritional losses. Even though ample capitalization exists, P/C insurers are still demonstrating restraint through underwriting discipline, effective enterprise risk management (ERM) programs, and conservative investment strategies, which collectively support our stable outlook on the sector.

Pricing increases are starting to accelerate. Price hikes in the excess and surplus (E&S) market stand out after the withdrawal of capacity by larger underwriters. Price increases are also evident in property, commercial auto, and directors' and officers' lines. This year will be an inflection point where pricing will likely outpace claims. Overall, we project the industry will report a 98% combined ratio this year. We expect underwriting profitability to benefit from sustained improvements in personal auto lines, which constitutes one-third of overall industry premiums.

Challenging market conditions have driven reinsurers 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 the permanence of alternative capital. They've also adjusted risk exposures, and are actively managing their capital structures through share buybacks, special dividends, and refinancing their maturing securities with more cost-effective ones. Operating conditions remain somewhat difficult despite modest year-to-date global aggregate reinsurance rate increases in reaction to elevated catastrophe activity in the past two years. However, expectations remain high for the upcoming June 1 Florida renewals.

Notwithstanding the overall decline in the new issue U.S. public finance market, bond insurers experienced strong premium rates that have continued this year. This, coupled with underwriting in the lower-risk city, county, and school sectors, has enhanced long-term risk-return prospects for bond insurers. The more important trend in underwriting is the uptick in insured secondary-market issues as institutional investors use insurance to manage investment-portfolio risk.

With revenue growth potential expected to be minimal for title insurers in the next two years, overall profitability will depend on their ability to manage operations throughout the mortgage cycle. Continued industry efforts to monitor operating efficiency closely, combined with higher investment income, have helped to maintain profitability and strengthen capital.

Private mortgage insurers (PMIs) will continue to benefit from favorable trends in employment and housing. With tight affordability, buyers—especially first-time buyers—will likely rely on mortgage insurance to help acquire homes. The industry's adoption of risk-based pricing allows for granular pricing; however, it could also pressure rates. Nevertheless, we expect strong earnings to continue.

Structured Finance

- Sector performance and expected credit outlooks remain stable.
- CLOs and subprime auto continue to be areas of focus, although recent subprime auto metrics have improved.
- We're monitoring the future LIBOR transitions, and watching for potential impacts from tariff uncertainty and equity market volatility.

What's changed?

Structured finance sector fundamentals remain generally stable. In terms of credit outlooks, we saw no change from quarter to quarter.

Key assumptions

Our base case is for continued moderate economic growth, and generally stable interest rates.

Key risks

For collateralized loan obligations (CLOs), we see more risk to junior classes as obligor credit and recovery ratings have trended downward. Market participants are particularly interested in 'B-' credits, and potential ratings movements, if economic conditions deteriorate. Leveraged loan standards and documentation provisions—as well as CLO documentation—are hot topics. This includes the proliferation of covenant-lite loans and EBITDA addbacks..

With asset-backed securities (ABS), the focus is on auto loan deals, especially those backed by subprime receivables. Our latest available data (March) showed improved collateral performance. Delinquencies declined as consumers used tax refunds to catch up on debt payments. Many of these refunds were also used as down payments for used-vehicle purchases, thereby increasing used-vehicle values, which helped recovery and loss rates. Year-over-year loss and recovery metrics also improved for the prime and subprime segments, and delinquencies held stable.

Our outlook for residential mortgage-backed securities (RMBS) is stable, amid low unemployment and rising home prices—albeit at a pace that is substantially slower than in recent years. As price growth starts to fall more in line with historical norms, affordability problems in many major markets will ease. Moreover, the threat of rising rates has subsided, with the 30-year fixed-rate mortgage near a two-year low. Interestingly, already-overheated markets on both coasts have forced individuals and companies to relocate to more affordable regions, which is putting upward pressure on prices in states such as Idaho, Colorado, Nevada, and Texas.

For commercial mortgage-backed securities (CMBS), there is ongoing stress from e-commerce and elevated industry competition. Another area of interest is lodging. Through April, revenue per available room (RevPAR) at U.S. lodging properties grew just 1.4% year-over-year, down from roughly 3% in 2018. Smaller markets are driving the (modest) gains, while the top 25 locations have logged a slight decline. Lodging exposure in CMBS conduits priced thus far in 2019 is 14%, down a little from 15% last year and 16% in 2017. Meanwhile, hotels back approximately 20% of CMBS single borrower transactions (by balance), down from more than 40% exposure in full-year 2018.

What to look for in the next quarter

We expect stable performance for structured finance overall in the next 12 months, especially for investment-grade classes. One area we continue to monitor is the expected cessation of LIBOR. While the event is more than two years away, market participants are focusing more and more on the transition—especially the details relating to replacement waterfalls, trigger events, and spread adjustments. In addition, the uncertainty stemming from potential tariff increases, and equity market volatility, both of which may have knock-on effects for structured finance credit conditions, could put our base case assumptions at risk.

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U.S. Public Finance

- Overall state credit quality remains strong across the country, with a majority (54%) projecting revenue growth of more than 3% in fiscal 2020.
- An expanding national economy is helping support stable credit quality, but the boost may be increasingly uneven as tariffs and job growth have a disproportionate geographic impact.
- Buoyed by strong state credit quality and a healthy economy, local government credit quality remains solid and stable for most municipalities.
- Although tariff and trade issues are affecting governments around the country, this hasn't hurt the credit quality of large ports. This is thanks in large part to an uptick in port activity as shippers and purchasers accelerated activity in contemplation of tariffs.

What's changed?

Despite ongoing trade uncertainty, state credit quality has remained strong, with most states indicating steady growth for fiscal 2020 following a good showing for income tax collections through April. There appears to be some emerging weakness in the real estate market, including residential. Should negative housing trends begin to emerge it would be a particular concern for local governments given dependence on property tax.

However, no news does not always mean good news, and the lack of a national infrastructure package puts states in the position of needing to find solutions on their own. Although economic growth remains able to support healthy state credit quality, the price tag for infrastructure improvements is high, and there are limited additional revenues available to address the needs.

As such, in recent years a majority of states have adjusted transportation-related revenues in order to address their needs through bond-financed capital programs. The funding increases sought are primarily gas tax increases, although tolling is also part of the conversation in some states. With many states carrying low-to-moderate debt burdens, raising revenues to support capital bonding programs could also help support additional economic change.

Even with cautious revenue projections, most states expect that fund balances will be maintained or grow in fiscal 2020. Supported by a solid financial backdrop from states, local government credit quality remains stable. Should the economy start to weaken, it will impact states first and then locals. However, with growth continuing around the country, there are limited signs that state governments intend to cut aid or otherwise negatively affect local government operations. Rising expenditures for local governments have continued to drive a wedge into operational balance, and those that were unable to build up reserves during this very long economic expansion will be at a distinct disadvantage in maintaining structural balance. Overall we expect most local governments will be able to weather the changes; however, a confluence of events such as a weakening economy and a cyber or weather incident would result in a different prognosis.

Key assumptions

- Continued broad-based local economic growth with limited disruption from equity market volatility.
- Ongoing federal support from federal government programs to supplement liquidity for state and local governments in extreme weather events
- Steady to growing economic forecast supported by low unemployment and favorable interest rates

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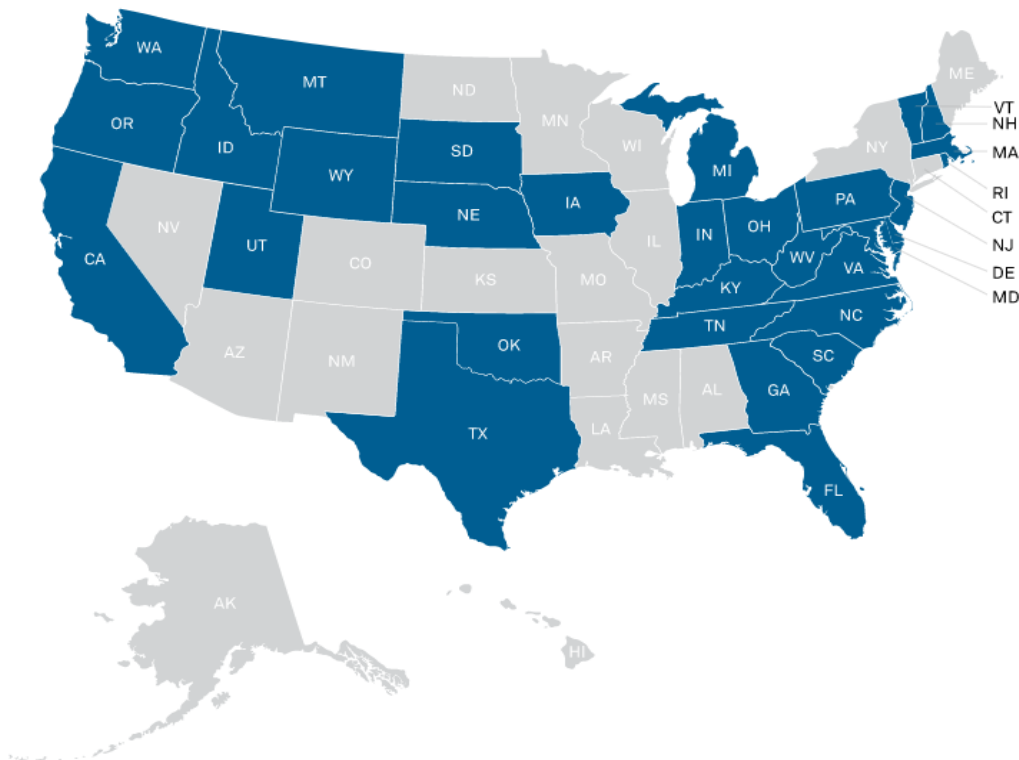
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States Reforming Transportation Related Revenues
(Motor Fuels and Others) 2013 to 2018



Source: S&P Global Ratings; NASBO; Transportation for America.
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Key risks

Tariffs and other policy changes remain important factors that could affect credit quality. So far, the biggest area of concern for escalating tariffs has been with manufacturing-based economies, particularly those with little diversity. Agriculture-based economies are also on the front lines of the trade war, and severe weather only exacerbates the pressures. However, the relatively small contribution of agriculture to gross state product isn't enough to move the needle on credit quality for most issuers. But given the next round of tariffs on \$300 billion of Chinese imports includes many more retail goods, the tariffs, if enacted, are expected to have a more direct impact on consumer pocketbooks. To the extent that this starts to hurt consumption, there could be a greater effect on spending habits and sales tax collections.

While environmental, social, and governance (ESG) factors have always been important to the operation of state and local governments, there's been a growing focus on them in recent years. An inability to identify or address ESG issues could hurt credit quality over time, weakening a government's ability to provide core services to its constituents. Still, more acute issues can require immediate attention, such as damage from a major weather event or a cyber-attack. To the extent that these issues hit an unprepared government, the risk of an impact to credit quality increases sharply.

Underfunded pensions and other post-employment benefits (OPEBs) remain a perennial problem for state and local governments. For those plans with good funding discipline, the pressures from unfunded liabilities are less likely to spike and create budgetary disruption. However, much like ESG factors, for those issuers who delay addressing mounting pressures the impact on long-term credit quality is likely to be much more severe.

Underlying all long- and short-term risks for state and local governments is political uncertainty created by policy changes at the federal level. Major shifts in the equity markets following policy announcements can drive losses from capital gains tax and pension fund earnings, and if changes to Medicaid reimbursements (a significant state budget driver) come again to the fore, the potential for credit disruption heightens. And while we find management has been the biggest factor in maintaining credit stability despite recent uncertainty, a prolonged period of turmoil could erode that foundation.

What to look for in the next quarter

There's potential for positive effects from a lower interest environment. Although municipalities can no longer take advantage of advanced refundings, lower rates are good for financing capital needs, and can also lure home buyers into the market.

The effects of major weather events on credit quality, particularly in places where there's potential severity of storms or other ESG issues, hasn't been met with a commensurate level of ESG planning.

Any trends of weakening state revenues would indicate potential credit deterioration for both the effected state and its local governments.

Public Finance - Canada

- Canadian provinces and cities continue operating in a very predictable and stable institutional framework, which is supporting their fiscal results and overall credit quality despite weaker economic growth.
- All ratings have stable outlooks, except for the City of Edmonton 'AA+' rating. We made only one rating change in the first half of the year, upgrading the City of Regina to 'AAA'.
- In a context of lower-than-expected economic growth in Canada, we expect provincial governments will favor spending restraint over politically difficult tax hikes as the main tool in their efforts to avoid higher deficits and control their debt burdens.

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What's changed?

With the 2019 budgets released in the first half, most provinces are continuing with fiscal-consolidation efforts. We expect softer economic activity and a reluctance to raise taxes to slow the pace of revenue growth for Canadian governments, causing them to pursue expenditure savings in order to maintain a balanced operating budget or chart a path back to balance. In the case of Ontario's budget, it seems that spending restraint, if achieved, could meaningfully reduce the province's fiscal deficits by 2023-2024, although its debt burden would still remain high compared to international peers'. On the other hand, in its first budget, Quebec's newly elected Coalition Avenir Québec (CAQ) government focused on moving its agenda forward by using the fiscal space that Liberal governments built to partly fulfill its campaign promises. Quebec's debt level remains high compared to other Canadian and international peers, so the CAQ government's prudence in this regard would be relevant from the credit point of view going forward.

Key assumptions

- A global economic slowdown would likely reduce Canadian real GDP growth 10-20 bps below the 2% increase, potentially delaying fiscal consolidation efforts in some provinces.
- We consider that Canadian provinces and cities continue to benefit from the very predictable institutional framework in which they operate.
- Canadian provinces account for the majority of the borrowing needs in 2019-2020.
- We assume that Canada, the U.S, and Mexico will continue with a trade deal that largely preserves existing cross-border production chains and capital flows. Any disruption on trade agreements could eventually affect some province's economic growth.

Key risks

Primary areas of risks that could undermine our base case are lower economic growth and negative effects from trade disputes, as well as public policy decisions that significantly delay fiscal consolidation, leading to much higher debt levels.

What to look for in the next quarter

Provincial governments' effectiveness to deal with fiscal deficits this year and beyond is key, as an over-reliance on debt to cover operating deficits could pressure some government's already-high debt levels. We will also monitor demographic trends as this could also place some public finance challenges in the medium- to longer term.

Related Research

- Credit Conditions Asia-Pacific: Return Of Uncertainty, June 27, 2019
- Credit Conditions EMEA: Double, Double, Toil And Trouble, June 27, 2019
- Credit Conditions Latin America: Optimism Fades Despite Fed's Pause, June 27, 2019

Only a rating committee may determine a rating action and this report does not constitute a rating action.

Appendix: Ratings trends and surveys

North America Banking Industry Trends

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

Note: Our BICRA Groups, Economic risk scores, and Industry risk scores are each classified '1' through '10', from lowest- to highest-risk. Economic and Industry risk trend are each classified as stable, positive or negative. For more information please see Banking Industry Country Risk Assessment Update: Jun. 2019. Source: S&P Global Ratings.

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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. Source: S&P Global Ratings.

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North America Corporate Sector Trends

U.S.

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

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	Retail; Transportation (Canadian airlines); Transportation (Canadian rails); Utilities; Telecom; Chemicals; Metals and mining; Building materials		
	Forest products			

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. Source: S&P Global Ratings.

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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. Source: S&P Global Ratings. Copyright © 2019 by Standard & Poor's Financial Services LLC. All rights reserved.

U.S. Public Finance Trends

Negative	Stable to Negative	Stable	Stable to Positive	Positive
Transit	Higher education	Local governments; states; Health care; 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. Source: S&P Global Ratings. Copyright © 2019 by Standard & Poor's Financial Services LLC. All rights reserved.

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. Source: S&P Global Ratings.

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