Domestic And Global Risks Continue To Cast A Shadow Over North American Credit Conditions

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Table Of Contents

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*(**Editor's Note:** Standard & Poor's Ratings Services' regional Credit Conditions Committees aim to enable and promote systematic and consistent consideration of economic factors into our credit research and identify vulnerabilities and risks for issuers. This article draws on participants' views discussed at the North American committee meeting held on Oct. 23, 2012.)*

Many of the risks that have weighed on credit conditions in recent months continue to do so as we approach year-end. Concerns about the so-called U.S. fiscal cliff of spending cuts and tax-relief expiration, the eurozone recession and sovereign debt crisis, and, perhaps to a lesser degree, the potential for a hard landing in China and an oil price shock, have continued to cloud the outlook for credit.

However, since the reelection of President Obama, U.S. party leaders have signaled somewhat greater willingness to compromise to avert the fiscal cliff. Primarily because of this development, Standard & Poor's Ratings Services lowered its assessment of the risk that the U.S. will again fall into recession to 15%-20% (from 20%-25%). Still, while we believe that Congress will eventually reach an agreement that avoids the cliff, we also expect considerable uncertainty and volatility along the path to that outcome.

Overview

- The odds of the U.S. falling into recession have fallen to 15%-20%, in our view.
- The eurozone crisis and the U.S. fiscal cliff remain the top risks.
- Rating trends are holding relatively steady, despite these challenges.

The Fiscal Cliff And The Eurozone Crisis Remain Top Risks

Standard & Poor's base case for the U.S. economy, which we reflect in our ratings, is for a continuation of modest, below-trend growth through next year. This scenario would likely be characterized by annual real GDP expansion of about 2.3% for 2013--roughly in line with the expected increase of 2.1% this year. This outlook entails a slight pickup in consumption spending growth, continued moderate equipment investment growth, and sharply stronger expansion in residential construction, compared to 2012, as well as slow improvement in the labor market.

Overall, the U.S. economy continues to heal, aided by very loose monetary policy. Housing is steadily recovering. Auto sales have been robust for a while, and demand for other big-ticket items has also been strengthening. Consumer confidence is climbing, while the labor market is gradually improving. However, business sentiment remains weak, with data indicating contraction in the manufacturing sector. Fiscal cliff worries will probably keep business investment slow through the end of this year. Still, we expect the improvement in housing to be large enough to outweigh the softness in equipment spending.

Standard & Poor's economists place the chance of a recession occurring at 15%-20%--a downside scenario that could primarily be triggered by the fiscal cliff or contagion from the euro area. Our upside scenario for the U.S. economy, which we now see as having about the same chance of occurring as the downside case, could unfold if the fiscal cliff is resolved more quickly than anticipated and a sharp bounce in private demand ensues. The upside scenario also assumes that a strong housing recovery amplifies growth.

While the fiscal cliff could be satisfactorily resolved in upcoming weeks, we expect the risk of contagion from the eurozone to remain for a while. The region is in recession, and while policy steps may have brought some calm to markets in the past several months, economic recovery in the region--not to mention addressing its structural issues--seems to be a ways off. In the base case, we anticipate no growth in real GDP for the eurozone as a whole in 2013, after an expected 0.8% contraction this year, with still substantial risk for a more widespread and much steeper downturn.

Meanwhile, recent evidence suggests that China's economic slowdown may be reaching a low point, supporting our base-case view of a "soft landing." Still, while the slowing of Chinese real GDP growth to about 7.5%-8.0% is probably acceptable to the country's policymakers, it could continue to have negative implications for economies and sectors that have been accustomed to China's turbo-charged and investment-led growth. In addition, territorial disputes between China and its neighbors can further damage trade flows and restrain growth in the region.

Lastly, while oil prices have moved within a relatively narrow range for the past couple of months, the eruption of hostilities in Gaza underscores the continued potential for turmoil in the Middle East to precipitate a supply-driven oil shock.

All in all, we expect these top risks to continue to result in considerable uncertainty through next year. (See table 1.)

Table 1

Top Risks--Q4 2012

Risk	Likelihood	Trend	Potential causes	Potential effects
Contagion from eurozone crisis	Plausible	Increasing	Eurozone banking sector problems deepen and spread	Financial market turmoil
			Collapse of systemically important financial institution	Increased investor risk aversion, with capital outflows from risk assets
			Eurozone recession becomes deeper	Funding markets stressed
			Exit(s) from the euro	Loose monetary policy continues
				Lower treasury yields and stronger dollar
				Uncertainty hurts consumer/business confidence, and consumer spending and business investment stall
				China slows down further or enters hard landing
				U.S. recession/slowdown
Excessive fiscal tightening in the U.S	Plausible	Increasing	Policy mistake/gridlock	U.S. recession/slowdown
				Monetary policy easing and lower interest rates
				Adverse impact on global economy

Table 1

Top Risks--Q4 2012 (cont.)				
Hard landing for China (real GDP growth falling to 5%)	Plausible	Stable	Disorderly deflation of real estate bubble	Reduced Chinese imports of commodities, raw materials, capital equipment
			Uncontrolled banking sector and local government debt problems	Chinese consumer spending weakens
			Political crisis/social unrest lead to loss of confidence and economic disruption	U.S. exports, agriculture, manufacturing hurt
				Adverse impact on global trade and growth
				Hurt trade and growth, particularly in SE Asia and Latin America, especially Brazil
				Deeper eurozone recession
				U.S. recession/slowdown
Oil shock (oil prices reaching $150 for WTI and staying at these levels for several months)	Plausible	Decreasing	Geopolitical developments in the Middle East cause a supply disruption	Higher gasoline prices
				Consumer confidence hit
				Weaker consumer spending
				Higher inflation
				U.S. recession/slowdown

Business Conditions And Profitability Trends Are Generally Satisfactory

In our base case, we expect business conditions and profitability to help support mostly stable rating trends for a majority of sectors. In general, issuers have positioned themselves for subdued economic conditions and nominal revenue growth. Corporate borrowers have remained focused on cost containment and continue to hold high cash levels.

Still, the soft global economy and elevated uncertainty have continued to weigh on some sectors, particularly metals and mining and capital goods, which we view as having somewhat weaker business and profit trends. Also, sluggish employment growth has continued to hold back many segments, such as student loan asset-backed securities (ABS), where we see business conditions remaining weak, given the continued challenging employment conditions for new college graduates. On the positive side, the improvement in the housing market is helping homebuilders, where we are seeing somewhat stronger business and profit trends. The following highlights our views on sector conditions and risks (also see tables below):

Banks

U.S. banks' combined earnings in Q2 2012 came out moderately ahead of our expectations, primarily a result of higher revenue growth, some of it nonrecurring. Loan-loss reserve releases continued to be the main factor driving profit growth. Although better than we expected in 2012, the relative profit trend, in our view, is likely to deteriorate somewhat in 2013. Unusually high mortgage banking related revenues and increases in capital markets based fee income will be harder to replicate next year. Moreover, key regulations, such as the Volcker Rule, may become final by year-end 2012, which will add to revenue compression and higher expenses. More positively, we do not expect capital distributions to increase meaningfully.

As a result of persistently low rates, we expect some banks to chase yield, which could lead to a downward creep in credit quality over time. Meanwhile, loan growth is expected to remain compressed in the low- to mid-single digits, mirroring subpar economic growth. Should we go over the fiscal cliff, we would expect to see deterioration in credit quality, primarily in consumer loan portfolios, including student loans, as well as in commercial and industrial (C&I) and consumer loan originations. Housing appears less of an incremental drag in the short term, although a resolution of the role of government sponsored enterprises (GSEs) is still key to the longer-term outlook.

Insurance

Life: In life insurance, we view solid capital adequacy and liquidity as key underpinnings supporting our stable outlook. We see prolonged low interest rates or a recession as risks to this outlook. We expect interest rates to remain low through 2013, creating a headwind against earnings growth and positive rating movements. Reduced crediting rates, more profitable new business, and higher asset management fees should partly mitigate the negative impact on net investment income, which we expect will be gradual.

Property & casualty (P&C): P&C ratings are generally supported by very strong capital, strong liquidity positions, and sustainable competitive positions. We expect the personal lines and reinsurance segments to experience flat to moderately positive earnings momentum, assuming average catastrophe losses, due to moderately favorable price increases. Commercial lines may experience a slight decline in earnings, as rate increases may be offset by loss cost trends and less of a benefit from prior-year loss reserve releases. However, claims arising from Hurricane Sandy will adversely impact full-year results for many P&C insurers and reinsurers.

Health: Health insurance revenues are benefiting from the slow but steady increase in payroll growth and below average medical cost inflation. We continue to expect the medical inflationary trend to gradually migrate back toward its higher pre-2010 level. However, there is increased probability that it could settle at a moderately lower trend. Key risks relate to the pace of economic improvement, growing fiscal pressures, health reform implementation, and higher-than-anticipated margin compression from a spike in demand for medical services and the migration of more volatile populations into managed Medicaid.

Nonfinancial corporations

We currently view the majority of ratings on nonfinancial corporate entities as stable. Leverage has decreased since 2007, issuers have attempted to fortify their balance sheets against capital market disruptions, cash levels have been built up, and maturing debt has been extended out. The ongoing search for yield among investors has enabled corporates to continue to raise capital, for both new issuance and refinancing at historically low interest rates.

Merger and acquisition activity remains below that of 2007. Capital investment has also been lackluster, helping to strengthen liquidity. Issuers have also "right-sized" to prepare for a nominal revenue growth environment and remain focused on cost containment. Should our downside scenario unfold, cyclical sectors such as commodities, consumer durables, technology, and business equipment would likely be harmed the most. Sectors exposed to discretionary spending, like leisure, lodging, airlines, advertising, non-staple retailers, and restaurants would also be hurt.

We note that maturities for corporate issuers rated 'B' and lower will escalate in 2014, to about 30% of total debt coming due, and remain at similar levels through 2016. Considering the amount of debt that these borrowers need to pay off or refinance, defaults may increase as these weaker issuers struggle--either because of unsustainable capital structures and/or weak operating fundamentals, or negative effects of years of underinvestment in plant and equipment, which has eroded competitiveness.

Nonetheless, against the background of anemic growth the U.S. leveraged finance market has proved to be surprisingly robust, primarily a result of historically low benchmark interest rates and investors' hunger for yield. We expect refinancing needs to continue to drive high issuance levels in 2013, barring serious market disruptions from such factors as the fiscal cliff.

U.S. public finance

Public finance credit ratings remain strong and stable. The past quarter's fewer than 300 rating changes, relative to the thousands of public finance ratings that exist, exhibited an extremely close alignment between upgrades and downgrades. State and local governments have been under pressure in recent years; however, strong responses by management--primarily exemplified in payroll and program cutbacks--have largely preserved the sector's overall credit quality. Utility and transportation systems are experiencing low growth, which reduces capital spending and financing needs, helps mitigate the need for fee increases, and contributes to perpetuating financial metrics commensurate with existing ratings. Cost cutting has also shored up credit quality in the not-for-profit health care sector, but we are assessing whether the capacity to further cut costs is diminishing. U.S. public finance issuers depend substantially on debt to finance capital projects because they lack access to equity markets, and tax and service charges provide limited excess margins and capacity for pay-go financing. Capital market access remains strong, and the low interest rate environment has benefited issuers by reducing financing costs and pressures on financial margins.

Structured finance

Consumer asset-backed security (ABS) fundamentals remain strong, and personal bankruptcies have been falling this year, but we believe key risks to consumer ABS collateral include continuing weak macroeconomic conditions and employment growth, and soft income gains for the next 12 months.

Auto loan collateral has performed well, but a changing competitive landscape and easing underwriting trends in the auto loan market remain a risk factor, particularly in the subprime segment. Subprime loan originations continue to expand as the percentage of used vehicles sold to subprime customers continues to rise.

Revolving credit has started to stabilize and bankcard charge-offs continue to show substantial improvement. But we expect a modest increase in charge-offs during the next 12 months due to easing underwriting standards. Employment conditions remain very challenging for new college graduates, affecting the credit performance of private student loan collateral.

The housing market is showing signs of recovery this year, but we expect prices and sales to slow down as we move into the winter months. The shadow inventory picture continues to improve gradually, and negative equity is in a better shape this year, but mortgages are still facing difficulties. Serious delinquencies and foreclosure rates have stabilized, but they are still elevated. While delinquencies are falling gradually, the cumulative loss rates for the 2005-2007 vintage years continue to increase at a slower rate across most products (prime, Alt-A, and subprime).

The commercial mortgage-backed securities (CMBS) delinquency rate remains high, but data continue to support signs of modest improvement in collateral performance. The rate of recovery will depend on job growth and consumer spending, among other factors. At the same time, continued global growth concerns could adversely affect CMBS performance going forward. The latest data suggest that liquidity has improved significantly over the past two years.

We expect collateralized loan obligation (CLO) performance to remain stable for the next 12 months as fundamentals remain steady, with low defaults and losses. Despite slow GDP growth and high unemployment, we project the 12-month speculative-grade corporate default rate to be at 3.7% by September 2013 under our base-case forecast, or 5.7% under our pessimistic-case forecast--compared to the long-term average rate of 4.5%.

CORPORATES	Business conditions 2011	2012	Relative Business & Profit Trends 2012 vs 2011	Expected Rating Trend 2012 vs. 2011
Aerospace & Defense	Satisfactory	Satisfactory	No change	Stable
Autos	Strong	Satisfactory	No change	Stable
Auto suppliers	Strong	Satisfactory	No change	Stable
Transportation	Satisfactory	Satisfactory	No change	Stable
Capital goods	Strong	Satisfactory	Somewhat weaker	Stable
Oil & gas	Satisfactory	Satisfactory	No change	Stable
Chemicals	Satisfactory	Satisfactory	No change	Stable
Forest products	Satisfactory	Satisfactory	No change	Stable
Metals & mining	Satisfactory	Satisfactory	Somewhat weaker	Negative to Stable
Building materials	Satisfactory	Satisfactory	No change	Stable
Real estate-Homebuild	Weak	Weak	Somewhat stronger	Stable
REITs	Satisfactory	Satisfactory	No change	Stable
Consumer products-durable	Satisfactory	Satisfactory	Somewhat weaker	Negative to Stable
Consumer products-food, beverage	Satisfactory	Satisfactory	No change	Stable
Consumer products-Personal Care, Consumer Services, Apparel, and Tobacco*	Satisfactory	Satisfactory	No change	Negative to Stable
Pharma & healthcare	Strong	Satisfactory	Somewhat weaker	Stable
Retail	Satisfactory	Satisfactory	No change	Positive to Stable
Media & entertainment	Satisfactory	Satisfactory	No change	Negative to Stable
Leisure & sports	Satisfactory	Satisfactory	Somewhat stronger	Stable
Technology	Satisfactory	Satisfactory	No change	Negative to Stable
Telecom/cable	Satisfactory	Satisfactory	No change	Stable
Utilities	Satisfactory	Satisfactory	No change	Stable
Midstream energy	Satisfactory	Satisfactory	No change	Stable
Merchant power/ppp**	Satisfactory	Satisfactory	No change	Negative to Stable
Oil Refineries	Satisfactory	Satisfactory	No change	Stable

CANADIAN CORPORATES	Business conditions 2011	2012	Relative Business & Profit Trends 2012 vs 2011	Expected Rating Trend 2012 vs 2011
Aerospace & Defense	Satisfactory	Satisfactory	No change	Stable
Auto suppliers	Satisfactory	Satisfactory	No change	Stable
Transportation	Strong	Satisfactory	No change	Stable
Capital goods	Satisfactory	Satisfactory	Somewhat weaker	Stable
Oil & gas	Satisfactory	Satisfactory	No change	Stable
Chemicals	Strong	Satisfactory	No change	Stable
Forest products	Weak	Satisfactory	No change	Stable
Metals & mining	Strong	Weak	Somewhat weaker	Negative to Stable
Building materials	Satisfactory	Weak	Somewhat weaker	Stable
Consumer products-non durable	Satisfactory	Satisfactory	No change	Stable
Pharma & healthcare	Satisfactory	Satisfactory	No change	Stable
Retail	Satisfactory	Satisfactory	No change	Stable
Media & entertainment	Satisfactory	Satisfactory	No change	Stable
Technology	Satisfactory	Satisfactory	No change	Stable
Telecom/cable	Satisfactory	Satisfactory	No change	Stable
Utilities	Satisfactory	Satisfactory	No change	Stable
Midstream energy	Satisfactory	Satisfactory	No change	Stable
Merchant Power/ppp	Satisfactory	Satisfactory	No change	Stable

BANKS	Business conditions 2011	2012	Relative Business & Profit Trends 2012 vs 2011	Expected Rating Trend 2012 vs 2011
Large complex banks	Weak	Weak	Somewhat stronger	Stable
Regional banks	Weak	Weak	Somewhat stronger	Stable
Finance companies	Weak	Weak	Somewhat stronger	Stable
INSURANCE	**Business conditions 2011**	**2012**	**Relative Business & Profit Trends 2012 vs 2011**	**Expected Rating Trend 2012 vs 2011**
Life insurers	Satisfactory	Satisfactory	No change	Stable
Property & casualty insurers	Strong	Satisfactory	No change	Stable
Health insurers	Satisfactory	Satisfactory	Somewhat stronger	Positive to Stable
Mortgage insurers	Weak	Weak	Somewhat stronger	Negative to Stable
Reinsurers	Strong	Satisfactory	No change	Stable
STATES	**Economic conditions 2011**	**2012**	**Relative Economic Trend 2012 vs 2011**	**Expected Rating Trend 2012 vs 2011**
US states	Satisfactory	Satisfactory	Somewhat stronger	Positive to Stable
Local Govt.	**Economic conditions 2011**	**2012**	**Relative Economic Trend 2012 vs 2011**	**Expected Rating Trend 2012 vs 2011**
US local governements	Satisfactory	Satisfactory	No change	Stable
USPF Healthcare	**Economic conditions 2011**	**2012**	**Relative Economic Trend 2012 vs 2011**	**Expected Rating Trend 2012 vs 2011**
Healthcare	Strong	Satisfactory	Somewhat weaker	Stable
USPF Housing	**Economic conditions 2011**	**2012**	**Relative Economic Trend 2012 vs 2011**	**Expected Rating Trend 2012 vs 2011**
Housing	Weak	Weak	No change	Stable
USPF UTILITIES	**Business conditions 2011**	**2012**	**Relative Business & Profit Trends 2012 vs 2011**	**Expected Rating Trend 2012 vs. 2011**
Electric Utilities	Satisfactory	Satisfactory	No change	Stable
Water and Sewer Utilities	Satisfactory	Satisfactory	No change	Stable

RMBS	Business conditions 2011	2012	Transaction Performance Trends 2012 vs 2011	Expected Rating Trend 2012 vs 2011
RMBS	Weak	Satisfactory	Somewhat stronger	Negative to Stable
RMBS Re-REMICS	Weak	Weak	No change	Negative to Stable
Servicer Advancing	Weak	Strong	Somewhat stronger	Stable
Tax Liens	Weak	Satisfactory	Somewhat stronger	Stable
CMBS	**Business conditions 2011**	**2012**	**Transaction Performance Trends 2012 vs 2011**	**Expected Rating Trend 2012 vs 2011**
U.S. Conduit/fusion	Satisfactory	Satisfactory	No change	Negative to Stable
Canadian Conduit/fusion	Satisfactory	Satisfactory	No change	Negative to Stable
Large Loan/Single Borrower	Satisfactory	Satisfactory	No change	Negative to Stable
CRE CDO/RE-REMIC	Weak	Weak	No change	Negative to Stable
ABS	**Business conditions 2011**	**2012**	**Transaction Performance Trends 2012 vs 2011**	**Expected Rating Trend 2012 vs 2011**
Auto Loans	Satisfactory	Satisfactory	No change	Stable
Auto Lease	Satisfactory	Satisfactory	No change	Stable
Credit Cards	Satisfactory	Satisfactory	No change	Stable
FFELP SL ABS**	Satisfactory	Satisfactory	No change	Stable
Private SL ABS	Weak	Weak	No change	Negative to Stable
Commercial Equipment	Satisfactory	Satisfactory	No change	Stable
ABCP	Satisfactory	Satisfactory	No change	Stable
Structured Credit	**Business conditions 2011**	**2012**	**Transaction Performance Trends 2012 vs 2011**	**Expected Rating Trend 2012 vs 2011**
CLO's	Satisfactory	Satisfactory	No change	Positive to Stable
SCDO's	Satisfactory	Satisfactory	No change	Stable
Market Value (includes Leveraged Funds)	Satisfactory	Satisfactory	No change	Negative to Stable
TRUP's	Weak	Satisfactory	Somewhat stronger	Stable
Structured Counterparties	Satisfactory	Satisfactory	No change	Negative to Stable
Timeshare	Satisfactory	Satisfactory	No change	Stable
Small Business	Satisfactory	Satisfactory	No change	Negative to Stable
Tobacco	Weak	Weak	No change	Stable
Transportation	Satisfactory	Satisfactory	No change	Stable
HF & PE CFO's	Satisfactory	Satisfactory	No change	Stable

We Continue To Expect Rating Trends To Generally Hold Steady

Standard & Poor's base-case economic forecast calls for continued modest growth in 2013. Meanwhile, somewhat increased expectations that the fiscal cliff would be averted have led to slightly lower risk of a U.S. recession, in our view. Although we expect that a compromise on the cliff would be reached, there is likely to be considerable uncertainty and volatility as fiscal agreements are negotiated. We also do not expect a quick resolution of the eurozone crisis, and this risk will likely continue to cloud global economic prospects through next year.

Despite these challenges, we expect overall rating trends to remain fairly steady over the coming quarters. Most issuers continue to hold a cautious stance, having braced for modest economic conditions, while maintaining strong liquidity. Private-sector leverage has fallen, capital markets have generally been accommodating, and issuers are benefiting from low borrowing costs. While we anticipate corporate defaults to rise slightly in 2013, they will likely

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remain below their long-term average. In our base case, we project the speculative-grade trailing 12-months default rate to be 3.7% by the end of September 2013, which would still be below the long-term average rate of 4.5%.

Related Research

- The Fiscal Cliff, Eurozone Economy, And China's Growth Top List Of Investor Questions For 2013, Dec. 5, 2012
- U.S. Economic Forecast: Back To The Future, Nov. 14, 2012