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FitchRatings

RISK HEADQUARTERS

APRIL 2022

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STAGFLATION RISKS RISE AS WAR UPENDS MACRO OUTLOOK

Credit Environment Overview

- The Russia-Ukraine war has fundamentally altered the global macroeconomic outlook and potential plausible risk scenarios. Our updated macroeconomic base case includes cuts to our global growth expectations amid a surge in energy prices and faster US monetary tightening. Existing inflation challenges have intensified as a result of the energy shock, bringing stagflation to the forefront of a plausible adverse scenario.
- The effect of a global stagflation scenario on our ratings portfolio would be felt in those sectors most exposed to higher input costs, heightened market volatility and tightened financing conditions. Industrial and travel-related sectors, and finance and securities firms especially in emerging markets show the greatest potential risk of negative ratings activity.
- Under our base case, emerging markets are likely to be disproportionately affected with greater sensitivity to price pressures leading to higher interest rate outlooks that will weigh on growth and slow fiscal consolidation and debt stabilization.

Even without a stagflation scenario, the Russia-Ukraine war has had credit implications for some sectors and issuers. While corporates in EMEA will bear the brunt, large western European banks' asset quality will also be pressured from direct Russian exposures. The war will also feed-through to European insurers, airlines, investment managers, and aircraft lessors, among other sectors. The war has also amplified asset performance risks for European structured finance transactions and covered bonds programs.

Risks to corporates in both the U.S. and Latin America from additional supply costs and demand risks have also been exacerbated by the war.

Emerging Risks…

Other emerging and related risks continue to simmer including risks of increased cyber attacks and the effects of the digital asset revolution from central bank digital currencies, decentralized finance, stablecoin and crypto lending. Pandemic risks also persist.

Key Takeaways:

1. The Russia/Ukraine war has fundamentally altered the base case and risk outlook for global credit
2. Stagflation is now a plausible risk scenario with an inflation "regime change" looking increasingly probable
3. Sectors with greater exposure to sustained high input cost inflation, global travel, capital market volatility and tightening financing conditions will be most vulnerable to a stagflation scenario

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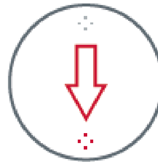
KEY RISKS: APRIL 2022

We reassess our Key Risks every quarter to summarize the principal areas of risk that could have the most impact on our rated portfolio over the coming two years.

This month, we updated our Key Risks to include stagflation risks and sustained direct trade disruptions that go beyond long-standing supply-chain challenges. Risks pertaining to the debt overhang and asset bubble, climate transition and China's financial risks remain.

Stagflation and Rising Rates
Below average growth combined with sustained high inflation and a rate hiking cycle combine to create a difficult macroeconomic environment for which many sectors are untested.



Debt Overhang and Asset Bubble
A return to 'normalized' valuations and default levels following an extended expansionary monetary and leverage cycle catalyzes an unwind in leverage that pierces asset bubbles in key sectors with broader financial implications

Sustained Trade Disruption and Instability in Supply Chain
Sustained high input cost inflation and supply-chain disruptions through late 2022 impact revenue and suppress sales in key industrial sectors while keeping consumer price inflation elevated

Climate Transition
Changing regulatory requirements, consumption trends and investor-driven 'green' capital allocation decisions pressure issuers to adopt more sustainable operating models and result in increased revenue volatility and capital costs/refinancing risks for the most exposed entities.

China Financial Risks Crystallize
Ripple effects from the property sector affect China's broader financial system with macroeconomic implications affecting the outlook for global commodity markets, investor confidence and demand.

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STAGFLATION AND RISING RATES

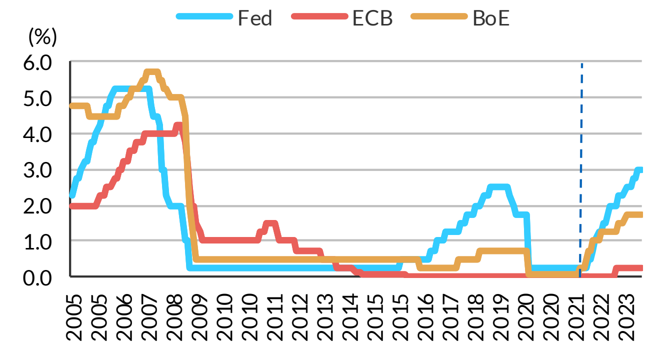
Key Developments

- Global stagflation is now a plausible adverse macroeconomic case.
- Since the beginning of the Russia-Ukraine war, the U.S. interest rate outlook has increased materially while the risks to growth have heightened considerably from a greater inflation and supply shock.
- Ratings would generally be resilient to a plausible stagflation scenario for a majority of global and regional sectors.
- However, there are areas of heightened vulnerability including for travel-related sectors, parts of emerging markets, certain financial sectors more vulnerable to heightened capital market volatility and tightening financial conditions, and industrial sectors more exposed to heightened input cost inflation.

Notable Research

- We have lowered our global growth forecast to 3.5% from 4.2% and increased our US inflation and Fed Funds target rate expectations.
- A global stagflation scenario is now plausible. The effect on ratings would be pronounced in several sectors.
- Emerging Europe, sub-Saharan Africa and APAC are likely to be the most affected regions under a stagflation scenario at the sovereign level.
- Ratings in 11 of 25 global corporates sectors would be vulnerable to a “medium” risk in the event of stagflation. Airlines would be the most vulnerable sector globally.
- Most global infrastructure ratings would be unaffected by stagflation, but EMEA and Latin American airports are likely to be subject to numerous outlook changes and a few ratings changes.
- Most financial institution ratings would only be modestly affected, but global aircraft lessors and financial institutions in EMs face the highest risks of negative rating actions.
- There is limited vulnerability for structured finance and covered bond ratings globally due to protection buffers in place relative to potentially worse asset performance.

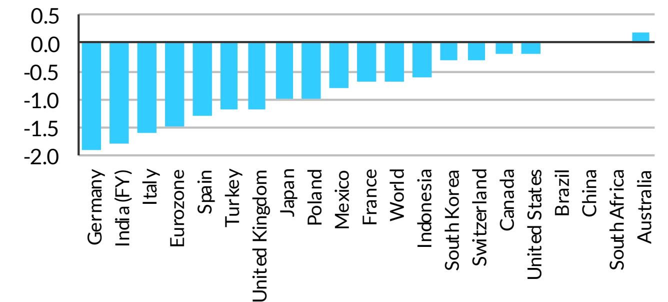
Policy Interest Rate Outlook – US, Eurozone & UK



Source: Fitch Ratings, Fed, ECB, BOE, Haver Analytics

Revisions to 2022 Annual GDP Forecasts

(Revisions since Dec 2021 GEO, pp)



Source: Fitch Ratings

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DEBT OVERHANG AND ASSET BUBBLE

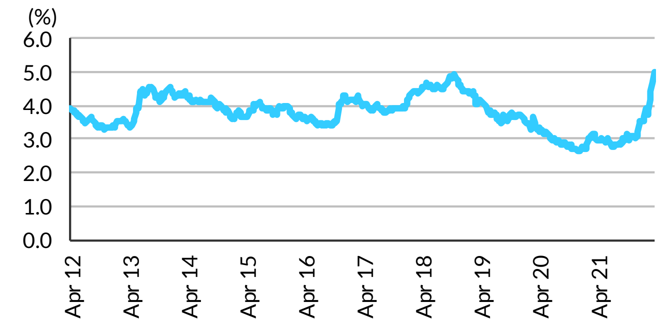
Key Developments

- The U.S. Federal Reserve raised interest rates for the first time in more than three years in March.
- Fitch updated its macroeconomic base case to include an end-year Fed Funds target of 2%, rising to 3% at end-2023. Our plausible adverse stagflation case includes the rate rising to 3% in 2022.
- Borrowing costs have risen materially alongside increasing policy rate and inflation expectations. The U.S. 30-year mortgage fixed rate average hit a 10-year high of 5% in April, up from 3.22% at the beginning of the year.

Notable Research

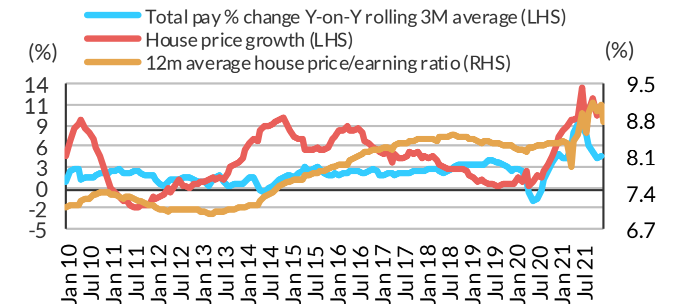
- U.S. home price growth should decelerate markedly this year.
- Overall, Fitch expects UK mortgage performance to remain robust. However, home price growth will significantly slow and rising household cost pressures may start to have an effect.
- The reduction in real incomes, increase in industry costs and potential for more severe and longer-lasting economic disruption from the Russia-Ukraine war increases downside risks to European structured finance and covered bond asset performance. Potential widening of credit spreads are a risk for those portfolios exposed to refinancing risk.
- A general deterioration in sub-Saharan African public finances means any further rise in government debt/GDP would be a potential negative rating action trigger for most sovereigns in the region.

U.S. 30-Year Fixed Rate Mortgage Average



Source: Freddie Mac

U.K. Real Pay Growth vs House Price Growth & Average House Price/Earning Ratio



Source: Fitch Ratings, ONS

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SUSTAINED TRADE DISRUPTION & INSTABILITY IN SUPPLY CHAIN

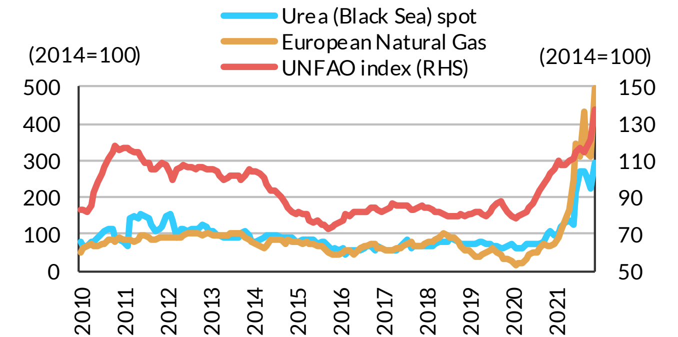
Key Developments

- The Russia-Ukraine war has resulted in a global commodity price shock that includes energy, materials and certain food staples.
- The potential for even further disruption to trade with Russia has elevated risks to the supply chain and prompted a broader rise in global inflation.
- Additional sanctions on Russia, especially those targeting energy, would substantially increase the risks of a broader supply chain, global growth and inflation impact.

Notable Research

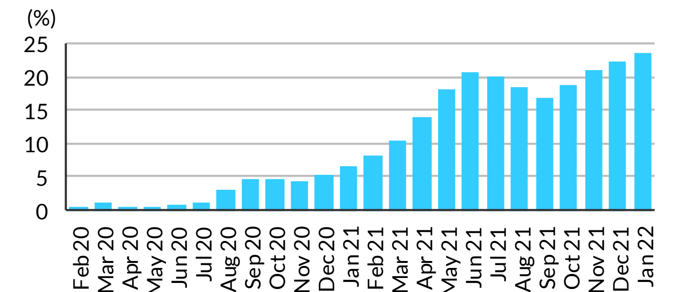
- Energy and food account for a higher share of household spending in poorer emerging markets, making them more vulnerable to the commodity driven rise in inflation. Russia supplies about 12% of the world's oil and 17% of its natural gas. Outright shortages and rationing are a particular risk for emerging Europe.
- A new European Commission policy aims to reduce dependence on Russian gas by two-thirds by end-2022. EU gas diversification will help to boost U.S. LNG projects.
- Fitch increased its oil & gas, metals & mining, and fertilizer price assumptions.
- Elevated input cost inflation will test US corporate pricing power and may dampen demand in some sectors.
- More than half of Fitch-rated sovereigns have implemented anti-inflation measures for households. There is a significant risk that these policies become entrenched, amplifying the policies' effects on public finances.

Fertilizer, Natural Gas and Food Prices



Source: Fitch Ratings, Indexmundi

Materials and Components for Construction Producer Price Index YOY Change



Source: Fitch Ratings, U.S. Bureau of Labor Statistics

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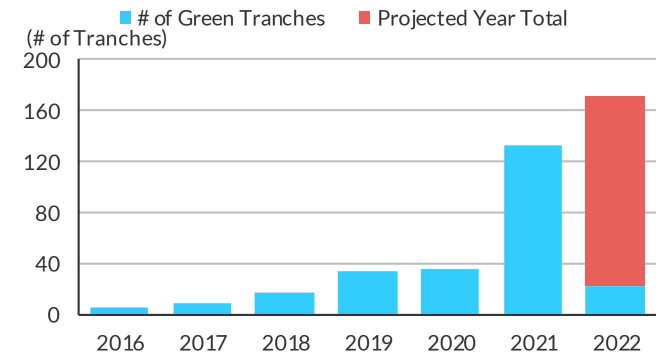
CLIMATE TRANSITION

Key Developments

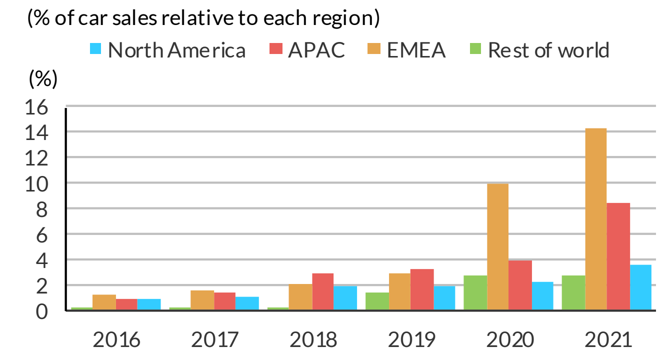
- The Russia-Ukraine war-related energy shock has raised questions around policy priorities for European energy to balance the need for energy security with the low-carbon transition.
- Rising commodity input costs, especially metals used in battery production, could delay certain renewable energy projects and have increased costs for manufacturers.
- Fitch expects the long-term growth in ESG-related securitizations and electric vehicle penetration to continue, despite the supply-chain challenges in the short term.

Notable Research

- Momentum for ESG-related securitizations should continue as issuers, investors and sovereigns align on incorporating ESG factors into their funding and investment strategies.
- The European Commission's REPowerEU policy package reflects shifting priorities to balance energy security and carbon transition.
- Decarbonisation costs will increase pressures on sovereigns' fiscal accounts but the effect on credit profiles will vary on policy choices and the extent of decarbonization required.
- The carbon transition may weaken U.S. automaker credit metrics as electric vehicle sales rise.
- Supply disruptions for key metals involved in low-carbon technologies will raise production costs for some battery-makers.
- Changing consumer and corporate behaviors and an increased focus on environmental targets could limit European airports' investment and expansion plans.



Source: Fitch Ratings, Bloomberg



Source: Fitch Ratings, Bloomberg

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CHINA'S FINANCIAL RISKS CRYSTALLIZE

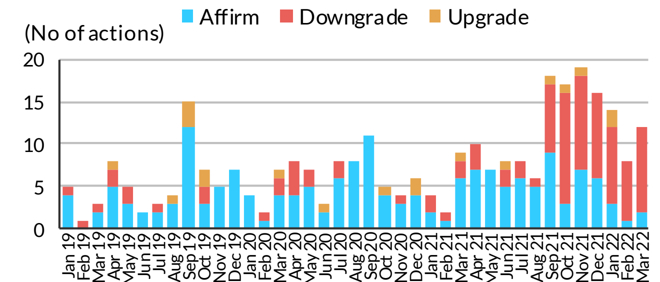
Key Developments

- Coronavirus outbreaks are adding to macroeconomic risks and could delay the pace and scale of recovery in 2022.
- Property sector stress has been more severe than we had expected. The decline in housing sales should ease slightly in 2H22 but funding access is likely to remain tight for developers. Most developers will continue to use internal cash to repay capital market debt.
- Spillovers from the real estate market could still introduce risks to China's growth outlook, should the recovery be more protracted.
- Following the introduction of targeted macro-prudential policy loosening, there is greater potential for more broad-based accommodative policy.

Notable Research

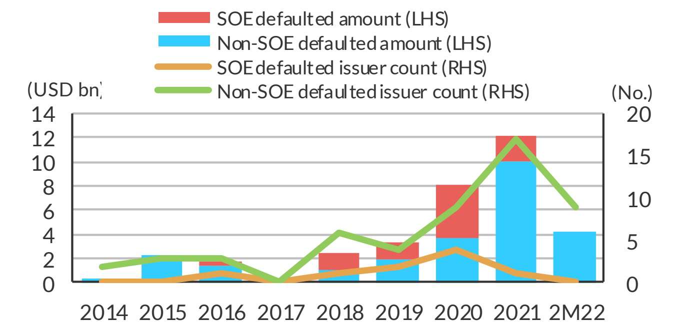
- Chinese property developers will continue to face a challenging operating environment in 1H22. Targeted policy easing should help to arrest the y-o-y decline in developers' internal funding.
- Economic risks increase the potential for accommodative policies that may affect our views on system leverage. For example, the loosening of mortgage loan-to-value ratios, if broadened, could raise household leverage.
- Delays to the publication of audited financial results for some property developers have led to downgrades and could add downward ratings pressures for others should it add to financing strains.
- State-owned construction firms are in a better position than privately owned ones to cope with the property market stress. Credit profile divergence is likely to accelerate.
- Additional property developer debt exchanges are likely in 2022 owing to continued weak sales and capital market refinancing remains unavailable.
- An increase in central transfers should ease local government fiscal strains.

Fitch's Rating Actions on Chinese Property Developers



Note: Data for the last month as of the day before publication
Source: Fitch Ratings

Offshore Defaults by Chinese Corporates



US dollar bonds and dim sum bonds
Source: Fitch Ratings, Bloomberg

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