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The Fiscal Cliff, Eurozone Economy, And China's Growth Top List Of Investor Questions For 2013

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The Fiscal Cliff, Eurozone Economy, And China's Growth Top List Of Investor Questions For 2013

Standard & Poor's Ratings Services has compiled a series of 26 "Top 10 Investor Questions For 2013" reports, each of which answers questions regarding a specific nonfinancial corporate industry sector. A number of key common themes arose among these reports. These include:

- The U.S. "fiscal cliff" of federal spending cuts and tax-relief expiration, and its potential to push the world's largest economy back into recession;
- The chance that Europe's recessionary environment and sovereign debt crisis will further curb growth across the continent; and
- The possibility that decelerating growth and a hard landing in China's economy will weigh on corporate revenues and profits for rated issuers with large exposures to that country.

If Standard & Poor's economists' downside scenarios for the U.S. and Europe were to occur--with a recession in one or both regions--cyclical sectors would likely be hurt most. These include commodities, consumer durables (including automobiles), and technology hardware and manufacturing equipment for businesses. Leisure, lodging, airlines, advertising, non-staple product retailers, and restaurants are also exposed to cutbacks in discretionary corporate and consumer spending. Weaker speculative-grade issuers in these industries (those rated 'BB+' or lower) would be most at risk of negative rating actions under these scenarios.

We note that despite these global economic uncertainties, Standard & Poor's currently views the majority of its ratings on nonfinancial corporate entities as stable. Global corporate ratings and new issuance continue to benefit from a favorable capital markets environment. This is primarily due to liquid capital markets seeking yield alternatives to treasuries, enabling corporate treasurers to continue to raise capital for both new issuance and refinancing at historically low interest rates.

Corporate balance sheets, liquidity and creditworthiness have vastly improved since the financial crisis. Corporate issuers continue to fortify their balance sheets to withstand potential systemic shocks. In turn, corporations across the majority of our industry sectors remain vigilant and focused on generating earnings in a flat to nominal GDP growth environment, which limits top-line revenue growth.

Standard & Poor's Economic Forecasts Project Slow Growth For the U.S., Stagnation For Europe, And A Soft Landing For China

As it stands, we see the risk of the U.S. falling into another recession in the next 12 months at just 15%-20%. In our base case, our economists forecast GDP growth next year of 2.13%, up from the 1.8% we previously projected. Additionally, we think it unlikely that the country will go over the fiscal cliff, assigning an approximate 15% likelihood of this occurring.

On the other hand, we assume Europe's economy will stagnate in 2013, with our base-case forecast assuming no GDP growth in the eurozone. We expect the economies of Spain, Portugal, Greece, and Ireland to actually contract next year, and project only slight growth in the larger economies of Germany, France, and the U.K. Our downside forecast, which we see as having a 40% chance of occurring, is that recession in the eurozone will extend into 2013.

Additionally, maturities for 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.

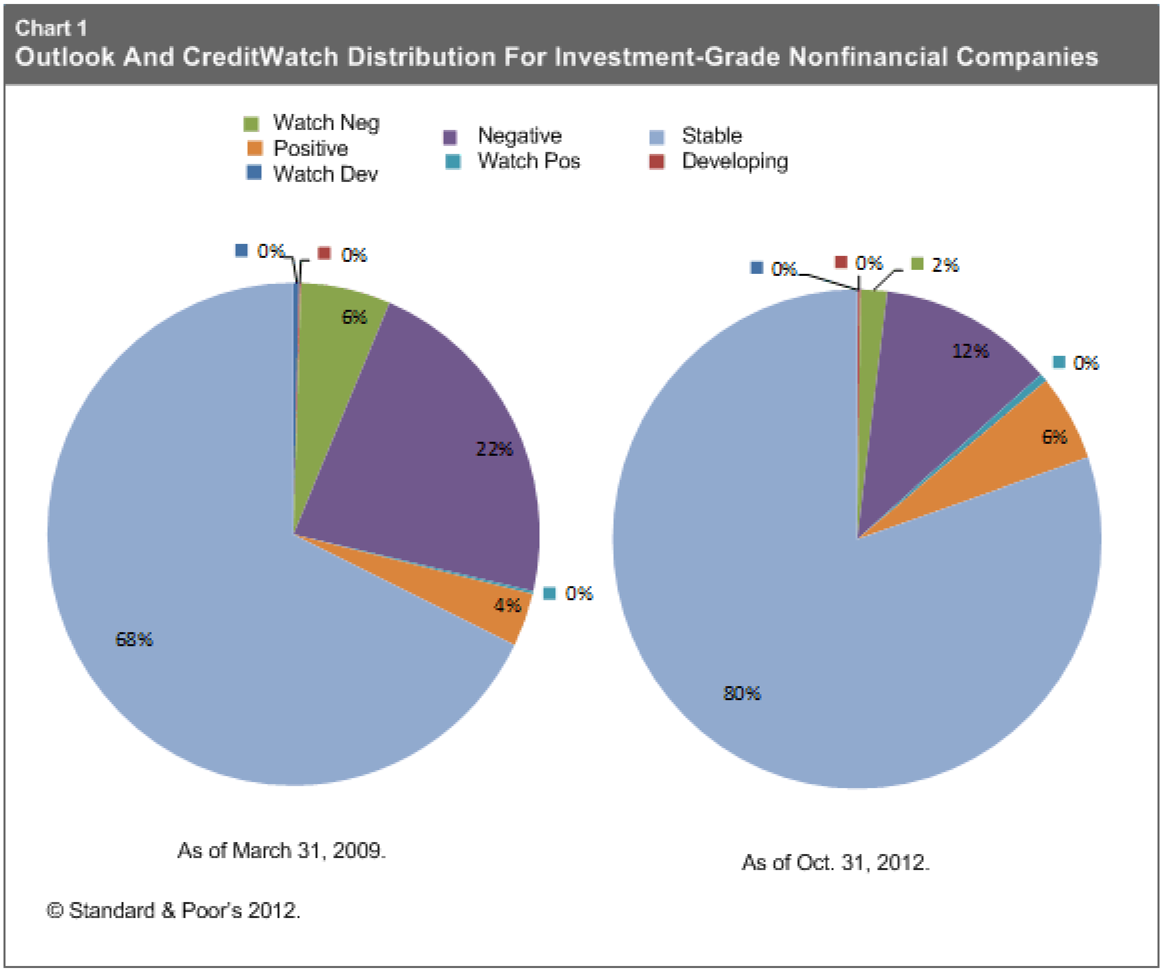
Nonetheless, against the background of anemic growth in the U.S. and a recessionary environment in Europe, the leveraged finance markets on both sides of the Atlantic have proved to be surprisingly robust, primarily a result of historically low benchmark interest rates and investors' hunger for yield. We expect refinancing needs to continue to drive high issuance levels in 2013, barring serious market disruptions from such factors as the U.S. fiscal cliff or a deepening sovereign crisis in Europe. In addition, we believe it unlikely that China will suffer a hard landing (which we define as GDP growth slowing to around 5% from its current level of around 8%), and expect the country's economy to expand at a still robust 8% or more next year. We also project mid-single-digit economic expansion in Latin America overall.

Corporate Credit Outlooks Are Generally Stable, Showing Improvement Since The Great Recession

Investment grade

In addition to our projections for 2013 of mildly improving economic conditions in the world's major countries, relatively easy access to the capital markets has combined with more stringent spending and cost controls among many borrowers to bolster balance sheets--including cash--and, thus, credit quality.

Standard & Poor's global ratings outlook distribution among investment-grade nonfinancial corporate issuers (those rated 'BBB-' or higher) has improved markedly over the three and a half years to Oct. 31, 2012. At March 31, 2009, stable outlooks accounted for only 68% of our overall ratings on these companies, while negative outlooks and CreditWatch listings were responsible for 28%. By Oct. 31, 2012, negative outlooks and CreditWatch listings had shrunk by 50% to 14% of the total, while stable outlooks grew materially, to account for 80% of the pie. (See chart 1.)



Source: S&P Quality Data Analytics.

When breaking down the negative rating outlooks and CreditWatch listings of investment-grade corporate issuers by region, the U.S. and Latin America have shown the greatest improvement since March 2009, while Europe, the Middle East, and Africa (EMEA) has also seen a marked 50% decrease in negative investment-grade outlooks and Watch listings. (See chart 2.)

Chart 2

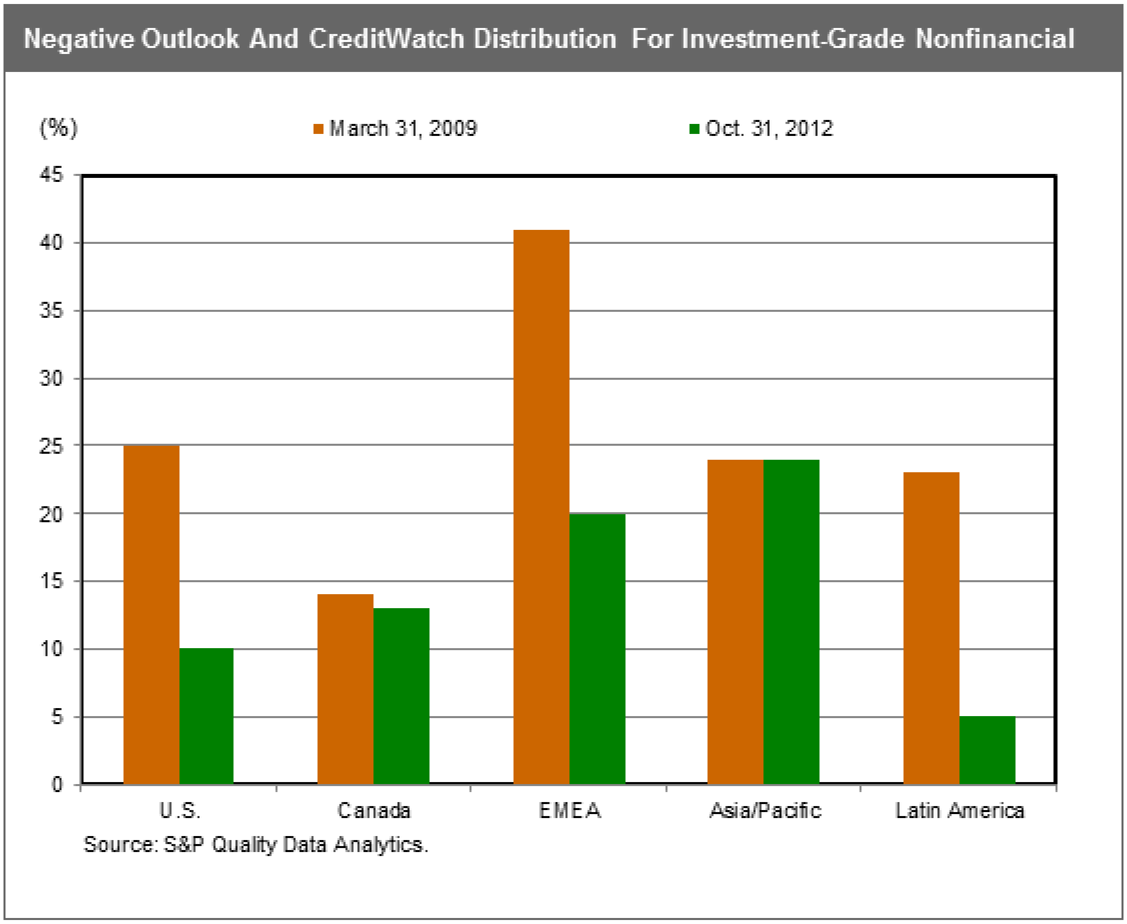
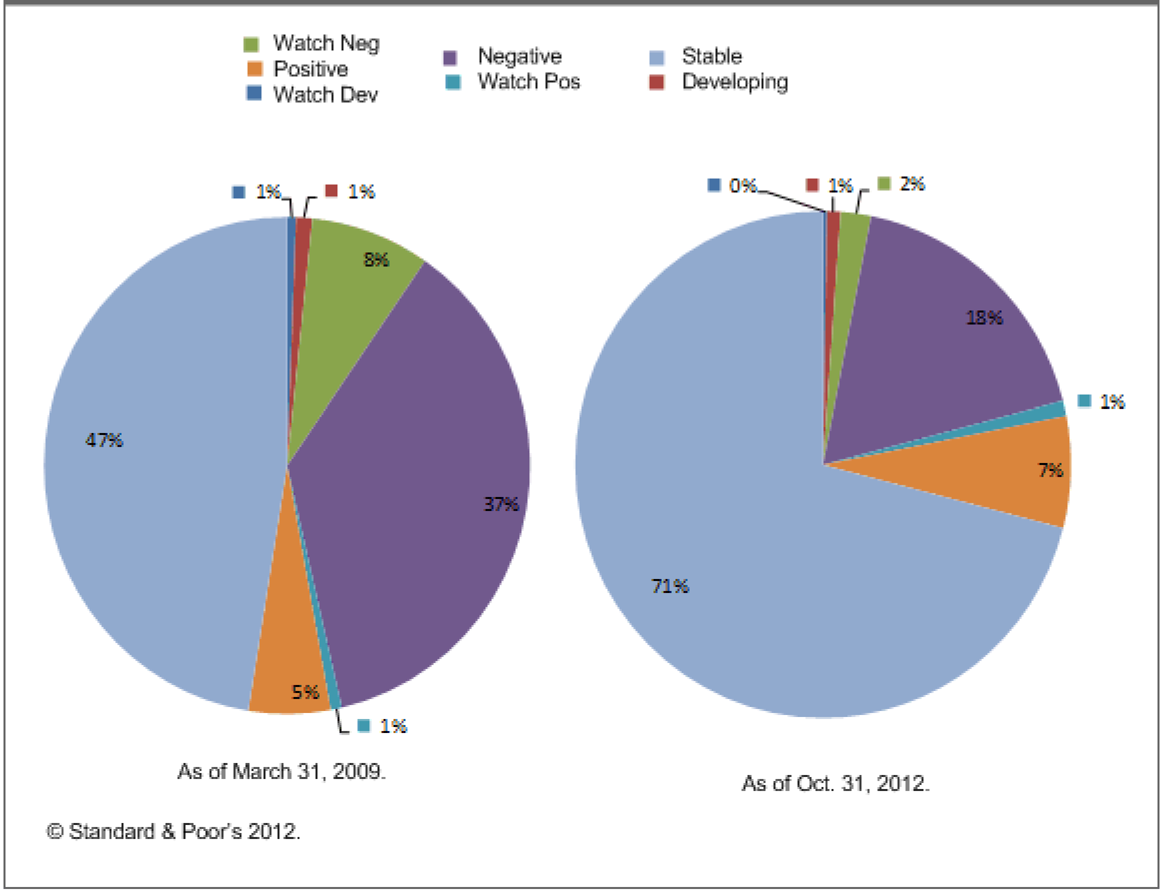


Chart 4 - Negative Outlook And CreditWatch Negative Distribution For Speculative-Grade Nonfinancial Companies

Speculative grade

Standard & Poor's global speculative-grade ratings outlook distribution among nonfinancial corporate issuers has also improved significantly over the past three and a half years. At March 31, 2009, stable outlooks accounted for only 47% of the global total, while negative outlooks and CreditWatch listings were responsible for 45%. By Oct. 31, 2012, negative outlooks and CreditWatch listings had shrunk to 20% of the total, while stable ratings grew materially, to account for 71% of overall speculative-grade ratings. (See chart 3.)

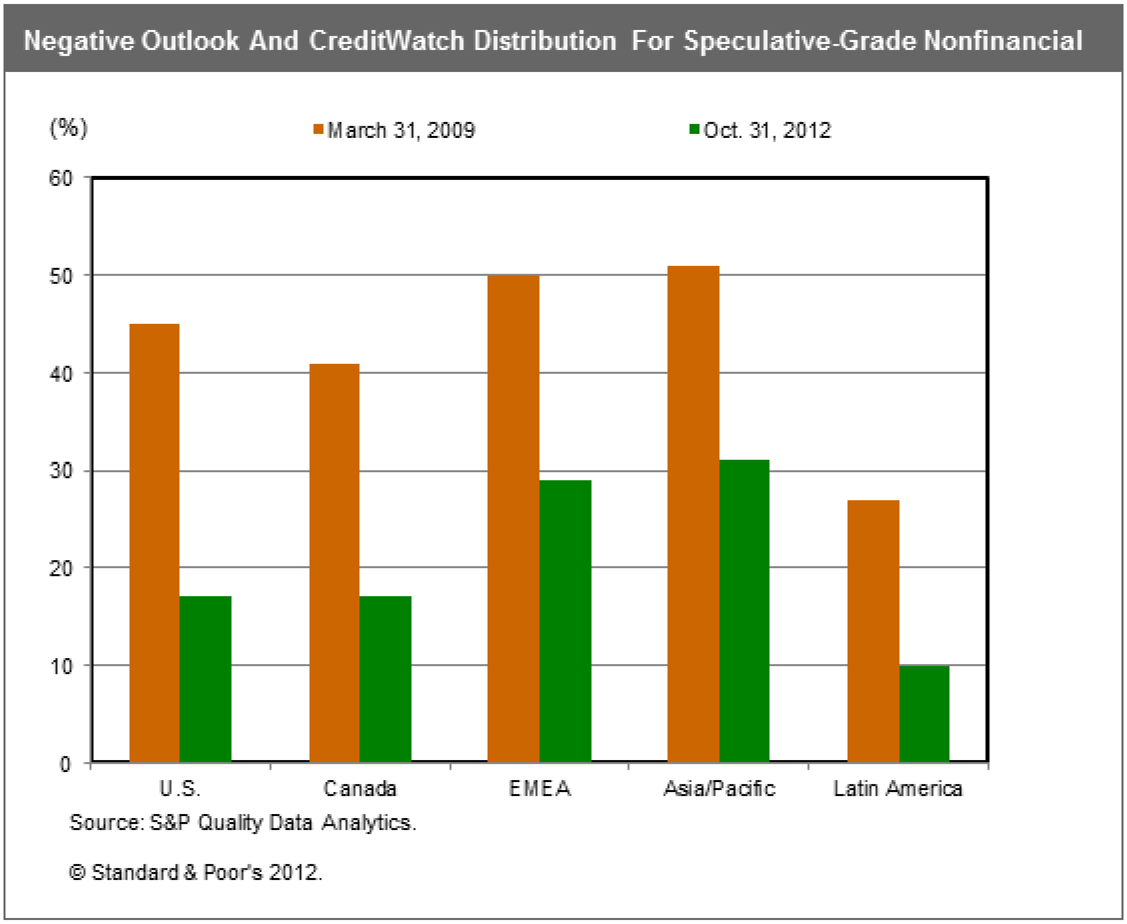
Chart 3
Outlook And CreditWatch Distribution For Speculative-Grade Nonfinancial Companies



Source: S&P Quality Data Analytics.

As for investment-grade rating outlooks, the regions showing the greatest improvement for speculative-grade outlooks have been the U.S. and Latin America, in addition to Canada. EMEA and Asia Pacific have also registered marked improvements, although relative to other regions, their combined negative outlook and CreditWatch distribution remains relatively elevated, at close to 30%. (See chart 4.)

Chart 4



Sector-By-Sector Overview

What follows provides an overview of Standard & Poor's "Top 10 Investor Questions For 2013" reports for various leading global sectors. The individual articles on all sectors and related topics will be made available shortly after the publication of this report.

Building materials

Building materials is an example of a sector that has recently improved operating efficiency. Industry participants have battled weak demand by reducing costs, though we note that the European market looks less promising than the U.S. market. Our outlook for building material and products companies for 2013 in the U.S. and in Europe is stable, despite only slowly growing markets in the U.S. and difficult conditions in Europe. Nearly all issuers maintain adequate or strong liquidity.

Forest products

We maintain a stable outlook on the industry as a whole. Nearly three out of four rated issuers currently have stable rating outlooks. However, we expect some companies--particularly those we rate speculative grade--to be more vulnerable to the economic and industry-specific risks. Differences in regions and product markets are likely to lead to

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varied financial operating results across the sector. U.S. housing markets are expected to continue to recover, leading to a sustained improvement in North American wood products manufacturers and timberlands operators' earnings from depressed levels. Latin America, China, and Indian economies are anticipated to keep expanding, leading to further acquisitions and capital expansion investments in those regions. Macroeconomic challenges remain concentrated in the U.S. and eurozone, which we believe will lead to continued demand declines for paper products and soft demand conditions for packaging-focused companies.

Retailing

Retailers in the U.S. and Europe continue to be affected by how consumers react to changes in the economy, based on their disposable income, employment status, and overall confidence in the future. We have seen a considerable slowdown in the amount that companies are investing. But this also results in a big build-up in cash, as companies conserve on working and fixed capital expenditures. This also leads to plenty of liquidity. As interest rates remain at very low levels, many retail companies have taken advantage of favorable market conditions. Higher-cost debt has been refinanced and maturities have been pushed out further. As we expect these conditions to prevail throughout 2013, our outlook for credit ratings is one of general stability.

Branded pharmaceuticals

We are currently in the middle of a unique time for the sector; the period from 2010 to 2014 is a multiyear patent cliff and was thought to be a threat to the global pharmaceutical industry. The normally robust revenues and cash flows of branded pharmaceutical manufacturers have come under pressure following the patent expirations; the patent cliff has also forced manufacturers to accelerate pipeline growth through acquisitions and by ramping up organic pipeline development. The current macroeconomic climate, U.S. health care reform, and austerity programs to reduce budget deficits in the European Union are other factors that are putting pressure on the global branded pharmaceutical sector. Although lower, margins and cash flow remain strong for the majority of our rated companies, as certain products are performing well and companies have realigned cost structures to meet the lower sales of once-blockbuster products. As a result, Standard & Poor's Ratings Services does not expect any significant changes to the industry's credit quality in the near term.

Telecom and cable

Like pharmaceuticals, the telecom and cable sector has proved relatively resistant to economic volatility because the products it provides have increasingly become viewed by consumers as necessities.

Utilities

Of course, this is also a sector providing services that are necessities. In many parts of the world, regulation is beneficial to industry players, which are allowed to pass along higher costs to customers through rate increases. That said, European power and gas providers may struggle somewhat if the continent's economy suffers a deep downturn.

Technology

Continued weak economic growth in the U.S., a recession in Europe, and a slowdown in Asia continue to put a damper on the industry's revenue growth. Additionally, the positive rating trends of the past few years have shifted to a much more balanced trend in 2012, which we expect to continue in 2013, as 75% of our ratings currently have stable outlooks. Europe is the region which currently has the highest negative outlook bias, as only half of the outlooks are stable and another one-third are either negative or on CreditWatch with negative implications.

Automotive

Our outlook for the sector globally is mixed, with 40% of our rating outlooks either positive or negative and the other 60% stable. Volume automakers face hurdles, including high costs and competition. These factors and economic uncertainty continue to translate into falling sales for Europe's mass producers in particular. However, we expect luxury automakers to do well because their more defensible market positions translate into higher margins.

Aerospace and defense

We expect ratings in these industries to be fairly stable in the next year, despite the diverging outlooks for the commercial aerospace and defense markets. Our outlook for commercial aerospace remains positive as aircraft manufacturers continue to increase production to reduce large order backlogs. Defense contractors, on the other hand, are facing increasing uncertainty as efforts to reduce the huge U.S. federal budget deficit pressure defense spending.

Transportation

We expect ratings to be mostly stable in 2013, but a weak economy and potential further European sovereign debt problems and recessionary pressures pose downside risks. Transportation companies are cyclical to varying degrees, but their vulnerability to economic downturns depends also on the balance of supply and demand in their markets and, for some, on changes in oil prices.

Capital goods

After the recovery of the past two years, capital goods companies are facing weaker demand globally. We don't expect widespread downgrade activity, but credit quality could see some slippage in 2013. The recession in Europe, tepid economic growth prospects in the U.S., a slowdown in China, and uncertainty about governments' abilities to resolve fiscal challenges are dampening business confidence and capital spending, creating conditions for negative operating performance trends in the industry. While the impact on ratings should remain moderate overall, it will vary by regions and subsectors, but will also depend on how management teams react to these changing conditions.

Oil and gas

Our ratings outlook for the sector is stable overall, although it faces some potential flux, as the industry is in a dynamic period. We expect crude oil prices to drop marginally, but remain relatively high. More important for the industry is the fate of the Chinese economy. Another major factor that we expect to continue affecting the industry is the hydraulic fracturing (fracking) and horizontal drilling boom/revolution in the U.S., which is proving a real positive game changer.

Metals and mining

We have a cautious view of the global metals and mining sector. In 2012, slower global growth has put pressure on metals prices, and metallurgical (met) and thermal coal prices are very weak in the U.S. and have been weakening elsewhere. In addition, global steel overcapacity, particularly with China's slowing growth, has led to pressure on prices. We expect many of these trends to continue into 2013, given economic weakness globally. The U.S. economy is a relative bright spot. This should lead to improved demand and, eventually, improving pricing for companies that benefit from a strong presence in the U.S. market. We are less optimistic about Europe. As a result, we believe metals and mining companies with exposure to European markets will remain challenged.

Chemicals

Many economic indicators that correlate to the performance of North American and EMEA chemical producers point to a slowdown during the remainder of 2012 and 2013. Notwithstanding a cyclical downside ahead, we anticipate credit quality in the chemical sector to be generally resilient due to improved cash flow and profit quality, the benefits of cheap natural gas in the U.S., and the diversified profile of many European producers.

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Packaging

The performance of the industry is closely linked to trends in consumer spending and GDP growth. So with most consumers cautious about their discretionary spending, the prospects for the packaging sector are far from buoyant. Nevertheless, while volume growth is unlikely to surpass the low-single digits in 2013, we believe that credit quality for the 36 packaging companies we rate worldwide should remain relatively stable.

Media and entertainment

If fiscal cliff related budget cuts were to come to pass in the U.S., advertising spending would suffer substantially. This, in turn, would likely lead to a significant number of downgrades in the media and entertainment industry, which is made up mostly of regional companies rather than global businesses that might be in better position to avoid the pitfalls of the fiscal cliff. In this light, the industry is notably less stable in the U.S. than it is in other parts of the world.

Gaming, lodging, and leisure

Borrowers in the leisure sector have improved their operating performance, with lodging proving strong because of business travel. Consumer spending, however, is depressed and may remain so, which will weigh on growth.