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2012 Global Credit Outlook: Sovereign Debt Problems Weigh On A Mostly Tepid Forecast

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In early December 2011, economists and senior analysts from Standard & Poor's Ratings Services gathered to address questions from RatingsDirect editors about what 2012 might hold in store for credit markets in various sectors. At a time when the sovereign debt crisis in Europe remained a looming concern and U.S. policymakers had yet to take decisive action on the federal budget, uncertainty cast a shadow over otherwise subdued forecasts for most sectors. In discussing the prospects for credit quality across a spectrum of securities, Standard & Poor's economists and analytical managers identified the major issues they believe global credit markets will face in 2012.

Overview

- A mild economic recovery is likely to continue in the U.S., while a mild recession is likely to persist in Europe. However, a failure to address sovereign debt problems in Europe and the U.S. could lead to a more pronounced downturn. Housing, employment, and consumer confidence remain the areas of greatest concern for developed economies.
- The economic outlook for emerging markets is more benign, with growth likely to be solid but not as pronounced as in recent years.
- The global banking system is likely to continue to be in a difficult position, in large part because of uncertainty over sovereign debt and financial regulation, anemic growth in developed markets, and a U.S. housing market that seems to still be a long way from rebounding.
- U.S. nonfinancial corporate issuers are likely to experience a balance between positive and negative rating actions, absent a significant market disruption.
- U.S. state and local governments will look to continue their efforts to align expenditures with resources, and for those that take a proactive approach, credit quality is likely to remain stable.
- Structured finance issuance will probably be tepid with a few relative bright spots, and 2012 activity is unlikely to pick up much from 2011 or come anywhere close to peak year issuance.

Participants included Deputy Chief Economist Beth Ann Bovino; Chief Economist for Europe, Middle East, and Africa, Jean-Michel Six; and Managing Directors John Bilardello (Corporate Ratings), John B. Chambers (Sovereign Ratings), Jayan Dhru (Financial Institution Ratings), Howard Y. Esaki (Structured Finance Ratings), and William Montrone (U.S. Public Finance Ratings).

RatingsDirect (RD): Recently we revised our view on the likelihood of an imminent recession in the U.S. to 35% from 40%. How significant is that change?

Beth Ann Bovino: The good news is that it's going in the right direction, the risk is declining to 35% from 40%. However, it's a minor decline in that reading, and a 35% chance of another recession is still a pretty significant weight on the recovery in 2012. One reason the likelihood has declined is that we're starting to see some momentum in the U.S. job market, with the addition of about 145,000 new jobs a month. It's not really as big a gain as we'd like to see, but it's still a positive trend. Manufacturing is also starting to recover from the disruption that followed the earthquake and tsunami in Japan last March, and consumers are spending a bit more than we had expected.

One of the areas that I see as keeping the risk of recession high is the potential for fiscal tightening in the U.S. The situation in Europe is turning into something much more severe and weighing on the U.S. economy as well, as is overall regulatory uncertainty, which is keeping people from spending more and keeping businesses from investing more, as well. While the holiday season is looking a bit better than earlier expected, people may keep their pocket books tight next year once the bills arrive.

RD: What about outside the U.S.?

Jean-Michel Six: We continue to expect a mild recession to take place in Europe in the first half of 2012. In fact, high frequency data revealed that in the fourth quarter of 2011, the manufacturing sector is already contracting in most European countries on the back of weaker demand from emerging markets and much more cautious consumers here in Europe. A factor that we are focusing on, particularly, is funding conditions. Capital markets have turned on European sovereigns in the second half of this year, and we have seen our spreads widening significantly against the benchmark provided by the German bund [government bond]. Countries like Italy are refinancing themselves on a 10-year maturity at over a 7% rate, which is clearly unsustainable in the medium term.

The crisis of confidence in financial markets, vis-à-vis European entities and borrowers, could, if it were to last, cause our outlook to move from a mild recession in Europe next year to a more severe recession, which we would call a true double dip, with negative rates of growth for all countries in continental Europe.

Bovino: The U.S. recovery should be able to withstand a mild recession in the eurozone; however, a more severe recession would have a much stronger impact. I think that could be one factor that could cause the U.S. recovery to slide into a recession as well.

RD: Are there any strategies available to developing economies to avoid recession? Have monetary policy efforts been effective so far? Do we expect any fiscal efforts?

Bovino: I think the monetary policy efforts that the U.S. Federal Reserve put into place as the crisis unfolded in 2009 had a very substantial impact and have helped the U.S. recovery. Keeping interest rates down to near zero and the Fed's alphabet soup of liquidity facilities have been strong supports for this recovery. However, with interest rates already so low, recent Fed actions will likely have only a small impact on growth. Indeed, the Fed has said that it really is not up to further efforts now. In order to keep this recovery in place, they're also looking to the fiscal policymakers to make a move, and I think that's where the risk is coming from. I'm concerned that U.S. policymakers will move to basically, just by default, fiscal austerity next year, allowing the payroll tax cuts and the long-term unemployment benefits to expire.

Six: The situation in Europe is complicated by the fact that we have a number of players here. There are 27 countries that belong to the European Union, 17 of which belong to the European Monetary Union. To get decisions quickly approved for such a large group is a major challenge. Important summits and events are going to take place in the next few weeks that may, hopefully, bring some clarification as far as the fiscal coordination across European countries is concerned. But, meanwhile, given the time it has taken policymakers to address in a unified voice the major challenges facing Europe today, the situation is putting a lot of pressure on the European Central Bank [ECB].

Since the beginning of the crisis in 2007, the European Central Bank has pursued several objectives. The first was to make sure that the financial system--meaning the banks in Europe--would still have full access to all the liquidity that they need to operate. And they've done that through what's called the Unlimited Tender System, whereby, essentially, banks can borrow as much as they deem appropriate from the ECB. The second is to keep interest rates at low levels, although certainly not as low as in the U.S. or in the U.K. The ECB has interest rates currently slightly above 1%, which is twice as high as in the U.K., for instance. But we expect further cuts in interest rates in the next month.

The third objective the ECB has been pursuing is to try to limit or contain the rise in sovereign spreads. And it has been particularly active in recent quarters, when spreads on key sovereigns like Italy started to widen very significantly. It has done so, not via quantitative easing, as the Fed and the Bank of England have done, but through a program called the Securities Market Programme [SMP], where basically the ECB intervenes on the secondary markets to buy back some government securities. In terms of amounts, the Fed's Quantitative Easing Program, since the beginning of its implementation, has amounted to about 12% of U.S. GDP. In the case of the Bank of England, the quantitative easing program, buying U.K. gilts [government bonds] on the primary markets, has amounted to about the equivalent of 14% of U.K. GDP. In the case of the eurozone, we are talking at the moment, through the SMP, of purchases of sovereign bonds on the secondary markets amounting in total to about 2% of eurozone GDP--a much more modest amount than in U.S. or U.K. programs.

The ECB is under a lot of pressure at this point to step in much more aggressively to support those sovereigns that are currently under pressure on the capital markets. But it is reluctant to do that before it gets some convincing evidence that those sovereigns have implemented effective medium-term fiscal programs. The ECB has been disappointed in the past, especially in August, when on several occasions the Italian government postponed announcements of fiscal tightening measures while the ECB was already trying to support Italy on the capital markets. So it is now becoming very cautious and it is waiting to see what kind of convincing, meaningful reassurance those sovereigns can provide before it acts more aggressively.

RD: The Labor Dept. says that U.S. unemployment has dropped to 8.6% from 9%. What are our employment projections for next year?

Bovino: We expect job growth to continue. However, we don't expect it to be strong enough to bring the unemployment rate down below 8% through 2012. That 8.6% unemployment reading is a little bit distorted, though I do think, overall, it was a good number to see. It did reflect greater job gains--that's always good news--but unemployment also declined largely because people left the labor force. However, the declines weren't tied to discouraged workers.

Through November 2011, we've seen an average 130,000 monthly job gains over the last 12 months. The ADP payroll numbers that came out just a little while ago also confirmed job growth. Private businesses have been starting to hire again, but government jobs continue to decline. So the job growth has largely come from the private sector. If the unemployment rate drops, or even holds below 9%, that's going to give consumers a little bit more confidence that maybe things are turning around. And maybe that'll get them out to the shopping malls a little bit more in 2012.

RD: Has unemployment also been a significant factor in slowing the recovery in Europe?

Six: Yes, and we are currently seeing a fresh deterioration in the labor markets of a number of countries, including France, Italy, and, of course, Spain, where the unemployment rate is still well above 20%. That's obviously an extremely alarming level. We're reviewing the private sector's hiring policies very carefully in the current financial context, which really dominates the outlook.

We need to be aware that banks operating in the eurozone have tightened their credit conditions markedly in response to higher prospective capital requirements, worsening asset quality in their loan books and their government bond portfolios, and because of a spike in their marginal funding costs. These new pressures are directly transmitted to the private sector and, in turn, cause companies to either suspend hiring or even turn to layoffs, as they now consider that 2012 is likely to be another very difficult year. And that leads them to postpone hiring plans that they had previously considered.

RD: How do economic conditions in the Asia-Pacific region compare?

Six: The outlook for emerging markets is much more benign than for developed markets. What we've seen in emerging markets, particularly in Asia, is that central banks tightened their monetary policies through the first half of 2011. They did that via higher interest rates and reserve requirements, and they did it because inflation was accelerating in their economies because commodity prices had been rising very rapidly for over a year. When the world economy started to slow in the middle of 2011, especially in developed markets, commodity prices eased somewhat. What we are currently seeing is central banks in emerging markets either on a pause or going back to a much more accommodative monetary policy stance. This is illustrated by cuts in interest rates in Brazil, for instance, or by the much lower reserve requirements the Chinese Central Bank recently announced it was imposing on banks.

Certainly, in the next 18 months, China will not experience the spectacular rates of growth that it enjoyed in 2010 but probably much more sustainable rates of real GDP growth in the 8% to 9% range, which is still the sort of growth that developed economies would love to see. Of course, if a severe recession were to take place next year--which is not our baseline scenario but certainly seems a real possibility--that would have a big impact on emerging markets. Investors and policymakers in those regions are watching developments in Europe and in the U.S. with a lot of attention, and to be honest, with a lot of concern. They really fear that the downturn in our developed economies could be more pronounced than we currently anticipate.

RD: Do you think a housing bubble is developing in China right now?

Six: House prices have gone up substantially in the past few years in the major urban areas of China. The central bank has been trying to curb the rate of growth of those loans that were feeding that bubble. There are structural factors behind the rise in house prices-–such as a large fraction of the population migrating from the countryside to urban centers. At the moment, we think that Chinese policymakers could still avoid a bubble bursting and instead orchestrate a soft landing for the housing market, but this is one area we are watching very carefully.

RD: What are the prospects for a housing turnaround in the U.S. in 2012?

Bovino: Home sales and housing starts have started to bottom out, but I don't think we're going to see any major rebound in housing through the next couple of years for several reasons. The unemployment rate, even at 8.6% (and likely to stay above 8% through 2013), is going to keep those people who would have been able to afford a house, if they had a job, from being able to get into the market. Those people who have a job are afraid that maybe they'll lose it, keeping them out of the market as well. Finally, there are still a lot of unsold homes, some in the process of foreclosure or still going through the courts. That's going to keep downward pressure on home prices and on housing this year.

RD: What do we think is in store for European housing markets for the year ahead?

Six: We're looking at two different cases. In some markets, excess supply continues to be a problem. This is particularly true in Spain, where according to bank estimates, over 800,000 dwellings are unoccupied. That's going to weigh on the house price outlook for the foreseeable future, especially combined with the weak economy. So for those markets like Spain, we think that the outlook remains negative for at least another 12 to 18 months before it can really hope to hit bottom.

On the other hand, a market like the U.K. is the exact opposite from a structural standpoint. There are not enough dwellings to meet the demand. House prices have declined somewhat after the bubble and are now stabilizing at lower levels. We don't see them recovering fast, because of overall economic conditions in the U.K., but certainly in the medium term, the prospects are more positive for house price increases.

There is a country in between that is a bit of a mystery, and that's France. France pretty much has excess demand, and that has been very supportive of house prices in the last decade. Since the beginning of the crisis, we would have expected prices to stabilize, but, in fact, they did that only temporarily and then started to rise again. House prices in the Paris area increased 18% in the 12 months to September 2011, which is a very worrisome rate in the context of an economic downturn and high unemployment. So France is a bit of an exception. We think that French house prices might actually contract quite a bit in 2012, between 5% and 10%.

RD: Have governments in Europe done anything to intervene in the housing market to improve the situation at all, or are they basically keeping hands off?

Six: They're pretty much running out of options, given the constraints on their overall fiscal positions. At the moment, by and large, the European governments do not have the room to maneuver to provide any meaningful support to housing markets.

RD: What about the U.S.?

Bovino: Home sales and housing starts have bottomed out and are starting to show some signs of recovery but at a snail's pace. The National Association of Realtors estimates that about eight and a half months of unsold homes are sitting on the market. That's well above the five-and-a-half to six month historical average range. So there's still a lot of excess supply. That's not even including homes that are in the process of foreclosure. Those distressed homes add many more months of supply. And according to the S&P/Case-Shiller reading, U.S. home prices probably won't reach pre-crisis levels for another five years.

One of the strengths in home sales and in housing starts is in apartments. Strong building in multifamily homes is largely tied to the rental market, probably because some people who did own a home can't afford one anymore, and those who are still working may have lost money in their 401(k)s or can't get a down payment together.

In terms of government moves, there's the recent Home Affordable Refinance Program [HARP], which now includes people whose homes are underwater [i.e., worth less than what they owe] but who are 12 months current on their payments. This opens up about one million new households to refinance their mortgages for a lower interest rate and puts a little bit more cash into consumers' pocketbooks. Hopefully, they'll spend some of that cash to get this economy going. But the program doesn't deal with all the distressed homes out there that need to be unwound.

RD: What's the financial state of U.S. consumers?

Bovino: They're facing a lot of headwinds. Consumer deleveraging of balance sheets has been going on for some time. Consumer credit dropped for 24 consecutive months during the last few years, but it has increased over the last few months. We've started to see consumers borrow a little bit more, largely in the form of non-revolving credit and student and car loans. The irony is that it appears that people who don't have a job are going back to school to find some new area to work in--and possibly getting that new car to go to those job interviews.

Still, overall, consumers remain cautious about spending. They have a good reason for that. Basically, real wages have been in negative territory throughout this recovery. Household net worth is only about 13% above the 2009 trough, and even though the unemployment rate has dropped a bit, it's still above 8% and not likely to fall below that for some time. I think people are still going to remain on the cautious side. They might spend a bit more, but I think they're still worried about next year.

RD: What about European consumers?

Six: We've seen several stages since 2008. First, we saw a generalized, broad rise in household savings rates across the region for understandable reasons--households starting to deleverage, adopting a much more cautious view. In 2010 that attitude changed somewhat in countries like Germany, France, and Italy, where typically household debt is below the eurozone average of 80%. And they cut their savings again, to maintain a certain level of spending.

One of the reasons we are concerned about the outlook for 2012 has to do with the household sector. We are seeing, yet again, a rise in savings rates across the region, and this is because of fresh uncertainties about financial markets and in political terms. Households are becoming nervous that maybe the crisis is going on for too long and something quite dramatic might happen. In 2012, we think that consumer demand across Europe is going to be anemic at best.

Bovino: The renewed spending that households have started looks like it has largely come from savings. The savings rate for U.S. households has dropped below 4%. This gives households a much weaker foundation for 2012. And if the U.S. Congress is not able to agree on some kind of decision to address the long-term debt issues the government faces and doesn't extend the payroll tax cuts and long-term unemployment benefits, we could see people get scared even a bit more with, of course, less to spend.

RD: What is our expectation in terms of interest rates and the possibility for inflation next year?

Bovino: The Fed is likely to keep their interest rates down to near zero through 2013, depending on the economic data. That's going to keep some downward pressure on long-term rates as well, particularly if the eurozone continues to remain in a weakened state. That, again, pushes money into U.S. assets.

I don't see near-term inflation as significant a risk. There's a lot of excess capacity out there in the market. And we'd need to see something closer to 6% unemployment just to be at a normal level for the U.S. So excess capacity in the labor market, excess capacity in the manufacturing sector, and excess capacity in the business sector are keeping inflation at bay.

RD: Even for food and fuel?

Bovino: The joke goes that, yes, inflation is stable--as long as we don't have to eat or drive anywhere. But those are moving targets, particularly oil prices. In the first half of this year, high oil prices caused the U.S. recovery to become weaker than it had been in late 2010. Oil prices hitting over a $100 a barrel, according to the West Texas Intermediate Crude readings, put upward pressure on prices. Households had to face paying another extra dollar for a gallon of gas. That's going to cut into household purchasing power and is going to make people nervous about what will happen down the road.

However, the impact of oil prices on the U.S. economy is less than in years past. U.S. consumption of oil as a percentage of total consumption in the world in 1971 was close to 50%. Now it's just a little over 40%. Household spending on energy as a percentage of household income was about 8% in 1981. Now it's about 5.5%. Why is this so? We've started to substitute for cheaper products, such as natural gas and coal, to reduce the overall energy bill.

If we did see a much more severe scenario for the eurozone that spread the contagion effect to U.S. banks, then lending in the U.S. could tighten. That could cause interest rates to rise and put downward pressure on the economy.

RD: In Europe, what are our expectations for interest rates and inflation?

Six: Monetary policies will remain very accommodative in 2012 and possibly beyond. We expect the Bank of England to keep its policy rate at 0.5% through next year and possibly the first half of 2013. And we expect the ECB to continue to cut interest rates, possibly down to 0.5%.

Transmission to long-term rates, however, has remained a problem. Refinancing in the capital markets has become much more expensive for sovereigns and large entities. Indeed, among the major uncertainties in the outlook for Europe next year are what will happen in capital markets and to long-term interest rates. If long-term rates for countries like Italy and Spain remain at their current levels, there is a risk that we would then move from a mild recession to a more severe recession. The answer to that dilemma is to be found on the political side and the European governance side.

Given the weakness of our economies, food prices and commodity prices are causing some hikes in the overall consumer price index, but inflationary pressures overall remain very low in our economies. The single exception to that is the U.K., where a combination of a much weaker exchange rate for the U.K. pound and rises in indirect taxes have caused inflation to accelerate in the past 18 months to over 5%. But this does not yet seem to be a major concern for the Bank of England, which remains almost entirely focused, it seems, on growth prospects in the real economy and wants to be sure that while the fiscal side is very tight in the U.K., the monetary side remains very supportive.

The inflation outlook in emerging markets in Asia, in particular, remains very correlated with the outlook for commodity prices as a whole. And, in turn, what's happening in developed markets partly affects them. We think inflation in China, for instance, probably peaked this summer at over 6% and is going to retreat to about 5% by the spring of 2012. We think, in other words, that inflationary pressures in China and Asia in general are somewhat going down at the moment and this will continue to be the case, in our opinion, in the next 12 months.

RD: How much does the global economic recovery depend on Chinese demand?

Six: The current account surplus of China is now down to 2% of its GDP from over 10% some while ago. So they have already become less dependent on exports than they used to be. The prime drivers of growth in China and Asia, in general, are capital spending and infrastructure spending even more than exports. Of course, exports remain a key engine of growth, but domestic demand now plays a much more important role than it used to.

Bovino: The U.S. doesn't export much to China, so what happens with Chinese demand is not going to have too much of an impact on U.S. growth.

RD: But it could really affect Latin America, right?

Bovino: It could through oil. The demand from China for oil and other commodities certainly was a significant strength for Latin America, Australia, and South Korea.

Jay Dhru: One other factor for China is that the government has reduced reserve requirements for banks so that they can start lending more.

RD: What is our outlook for sovereigns in 2012?

John Chambers: Beth Ann and Jean Michel have just outlined a lackluster if not bleak outlook for near term global economic growth. Although our sovereign ratings look at more medium-term and fundamental factors, our outlook on sovereign ratings matches theirs in many ways.

On Dec. 5, 2011, we took negative CreditWatch actions on 16 of the 17 members of the eurozone. [See Related Research, at the end of this article, for more on recent research and ratings actions on sovereigns.] Only the Hellenic Republic was excluded and it's rated 'CC'. In our CreditWatch action, we said that systemic stresses in the eurozone have risen in recent weeks to the extent that they now put downward pressure on the credit standing of the eurozone as a whole. We identified five interrelated factors that we believed produced these systemic stresses:

- Tightening credit conditions across the eurozone;
- Markedly higher risk premiums on a growing number of eurozone sovereigns, including some that are currently rated 'AAA';
- Continuing disagreements among European policymakers on how to tackle the immediate market confidence crisis and, longer term, how to ensure greater economic, financial, and fiscal convergence among eurozone members;
- High levels of government and household indebtedness across a large area of the eurozone; and
- The rising risk of economic recession in the eurozone as a whole in 2012.

RD: What are you looking for to resolve your CreditWatch?

Chambers: Our CreditWatch review of eurozone sovereign ratings will focus on three of the five key factors that form the core of our sovereign ratings methodology: the "political," "external," and "monetary" scores we assign to the governments in the eurozone. Our analysis of "political dynamics" will focus on both country-specific and eurozone-wide issues that appear to us to be limiting the effectiveness of efforts to resolve the market confidence crisis. Our analysis of "external liquidity" will focus on the borrowing requirements of both eurozone governments and banks. Our analysis of "monetary flexibility" will focus on ECB policy settings to address the economic and financial stresses the countries in the eurozone are increasingly facing.

RD: What about the other 10 members of the EU that are not part of the eurozone?

Chambers: Of the 10, the rating on Hungary is most at risk of a downgrade. Our 'BBB-/A-3' ratings on the country are on CreditWatch with negative implications. We plan to resolve that CreditWatch once we have more information about Hungary's policy framework and the likelihood of an IMF/EU agreement being reached. As for the other EU members that are in Central and Eastern Europe, one factor we'll be looking at is the ability of their banks to maintain access to international markets. This is as much a story about required capitalization and liquidity needs among the creditor banks in Western Europe as it is about growth prospects in CEE [Central and Eastern Europe].

RD: On Aug. 5, 2011, Standard & Poor's lowered the rating of the U.S. federal government to 'AA+'. Is the rating still under pressure?

Chambers: The Fiscal Committee's inability to agree on fiscal measures that would stabilize U.S. government debt as a share of GDP is consistent with our Aug. 5 decision to lower our rating to 'AA+'. However, we expect the caps on discretionary spending and the sequestration mechanism to achieve additional savings as laid out in the Budget Control Act of 2011 (BCA) to remain in force. If the BCA is watered down, downward pressure on the ratings could build.

RD: What are the prospects for the larger sovereigns in Asia and the Pacific?

Chambers: Among APAC [Asia-Pacific] members of the G20, we have stable outlooks on the foreign currency ratings on four: Australia (AAA), China (AA-), and Korea (A). A worsening external environment would hurt their near term growth, of course, but we believe they have enough resilience at their various rating levels-–thanks to the external reserves they've built up and to the characteristics of their individual government debt dynamics--to weather the coming storm. India (BBB-) also has a stable outlook, though less resilience than the other three because of high inflation, reform fatigue, and high general government debt. Indonesia, at 'BB+', has a positive outlook. We've said that the rating could rise if inflation pressure diminishes, the external debt burden declines, the sovereign's balance sheet improves, or reforms such as a subsidy rationalization suggest that fiscal and external vulnerabilities are further reduced. Finally, Japan, at 'AA-', has a negative outlook. We could lower the ratings if the government's debt trajectory follows its current course or begins to erode the nation's external position.

RD: And for the larger Latin American sovereigns?

Chambers: Of the G20 members, all have a stable outlook. Last month, we raised Brazil's foreign currency rating to the same level as Mexico's--'BBB'. We said then that the upgrade of Brazil was supported by the current administration's growing track record of prudent macroeconomic policies, including fairly consistent primary surpluses of close to 3% of GDP. For Mexico, the stable outlook reflects Mexico's cautious macroeconomic policies that keep its fiscal and external debt burdens steady against the vulnerabilities posed by a comparatively low growth environment. As for Argentina, rated 'B', the stable outlook balances the upcoming fiscal challenges and the restricted financing alternatives against strong external performance and a diversified economy.

RD: What impact might the European debt crisis have on financial institutions if it were to worsen next year?

Dhru: Downgrades in the global banking universe peaked in 2009, with downgrades exceeding upgrades by a 3 to 1 ratio. The downgrades were predominately in the U.S. and Europe during that time. Since then, there has been a period of stability, which was broken in the second half of 2011. At that point, as the European sovereigns continued to worsen, so did the banking system. And downgrades picked up momentum in the second half of 2011, largely for European financial institutions. We expect that the fragile peace that we see in the banking system to be just that over the next year.

Of the top 37 global banks, 23 are either on a negative outlook or on CreditWatch negative. This means that there is going to be rough sailing for the financial system as a whole over the intermediate term.

RD: What are the key credit risks for financial institutions as we go into 2012?

Dhru: The first one is the uncertainty. When Italy can go from a 4.5% cost of borrowing to 8% in one month, it means there is significant uncertainty in the market. And when you don't know what is fear driven and what's driven by fundamentals, that has a significant impact. So the uncertainty manifests itself in the form of no amount of capital is enough, no amount of liquidity is enough. This occurred in 2008 and 2009 in the U.S. and the global markets, broadly. We're seeing the same thing again.

The second is that growth is anemic. That is more of a manageable problem because banks have historically grown significantly and then have gone into a deleveraging mode. That part is manageable, but that is also a headwind that the banks are facing.

Then, finally, the fact that the U.S. housing markets have not completely bottomed, because a Fannie Mae Freddie Mac solution has not been found, is yet another issue that the banks are facing.

RD: Do you foresee banks globally having trouble meeting their regulatory capital requirements?

Dhru: Banks have improved significantly over the last two or three years from a capital standpoint. So the good news is that they're in a better position today than they were in 2008. That said, over the next several years Basel is looking for increased capital for banking systems globally. The U.S. number could be anywhere from $300 billion to $400 billion over that period of time.

You can meet it one of four ways. One is to deleverage. If you just take a very simple 10 to 1 ratio, then you've got $3 trillion to $4 trillion of financing that won't be met. The second way is to retain earnings, and the more banks retain, the fewer dividends there will be, the fewer buybacks there will be. The third way is a combination of the two: reducing leverage and increasing retained earnings. The fourth way is to issue more equity.

It's difficult to see banks attracting new capital at this point. So the downside, as we've been saying, is that the impact of more capital regulatory hurdles is shrinkage of credit or a significant increase in credit costs.

RD: And if we have that, will banks be able to begin lending money to companies or consumers next year?

Dhru: As of now, only the commercial and industrial loans have shown growth. Increased lending will depend on the path the economy takes. So far, loan growth in 2011 has been 9% versus last year according to the Fed. And commercial and industrial [C&I] loan growth is largely driving that. However, this may slow down if the economy also slows. But even if a strong growth rate in C&I has not been able to offset declining balances in real estate lending or other loan categories, we do not see much change ahead and look for really tepid loan growth in 2012 and into 2013. Again, this is to be expected as banks reduce leverage.

RD: And the profitability outlook, therefore, must be pretty constrained.

Dhru: Profitability should decline across the board. Top-line growth would be tough in a close to recession environment globally, while credit costs could also flare up as the economy stays along the bottom. Credit costs have been manageable but they could rise. In the U.S., we see pretax return on revenue dropping to around 19%-20% in 2012 from an estimated 25% in 2011--this is core profitability--and falling further in 2013 to around 17%-18% because we expect higher operating costs brought on by regulation and compliance and more demand to deleverage.

RD: Do U.S. banks have any competitive advantages over their European and Asian peers at this stage?

Dhru: Yes. The U.S. banking system is resilient. It builds up risks over time, quickly recognizes the risks, and purges those risks and starts anew. The capital markets' expertise, financial engineering skills, innovation--these are the advantages that the U.S. banking system brings to the global market. It is, however, facing significant headwinds from the regulatory environment, an uncertain economic environment, and increased capital demands.

RD: What would lead banks to resume large scale lending to consumers, which might help the economy?

Dhru: If the health of the consumer improves--which is directly tied to the economy--it could spur more lending. But the reality is that personal income is stagnant and consumer confidence is shaky. Consumer spending accounts for more than two-thirds of the U.S. economy. So whether or not consumer lending is reignited is a big deal for the overall economy. Right now, consumers seem to be dipping into their savings as opposed to borrowing more.

RD: Have the banks been able to position themselves to resolve some of the troubled mortgages that they've been holding?

Dhru: In their roles as servicers, I think we've seen evidence of modification efforts by the banks--both those methods supported by Freddie and Fannie--such as HAMP, HARP, and HARP2--and private methods. Banks are also willing to work with borrowers to resolve troubled mortgages through short sales and some forms of principal forgiveness. But there's not a systematic move toward this.

RD: To what extent do you expect non-banks--private equity firms, hedge funds, and others--to begin to pick up some of the funding activity that banks traditionally handle?

Dhru: During a time of difficulty, non-banks like finance companies often come into the market. Finance companies generally rely on wholesale funding, which is an avenue that is getting more and more difficult to pursue. So you really don't see new start up finance companies coming in. That's one avenue that's closed, at least for now. Hedge funds probably not at all, because this sector is also moving toward better liquidity, which means that they have been offering better terms to investors, like shorter lock-ups. And they have moved toward higher liquidity options, like exchange-traded products. So we've seen actual reductions in less liquid side activities or even other less liquid as a class, such as OTC [over the counter]. Thus, we don't really see it coming from hedge funds.

We don't have clear data or evidence that private equity [PE] companies are picking up banks' funding activities. But it is fair to say that whenever there are distressed opportunities, this is really where PE firms could come in. We don't think that they will replace banks just because there's a gap, but the firms we cover would only see part of the risks be taken over there. The only area that we're seeing sizably picking up the bank lending requirements are the capital markets.

RD: What are the key risks non-banks--financial institutions, asset managers, insurance companies, and funds--are facing?

Dhru: This environment has actually shown that the asset-management business is inherently stable. Despite a very difficult environment, the asset managers have proved themselves to be nimble. None reported a pretax operating loss or an aftertax net loss. Those companies with a more balanced mix of assets under management performed relatively better in the down market--and we would expect that--and demonstrated the benefits of business diversification. We also expect some bounce back in operating performance in the fourth quarter, barring any unexpected year-end calamity to the global financial markets. If there is a sustained Assets Under Management (AUM) outflow, we could see pressure on revenues, especially for those with equity concentrations.

For insurance companies, the sustained period of low interest rates and credit instability pose long-term challenges. They've been able to actually maneuver through that pretty nicely so far, and that's because their liabilities are less confidence sensitive than banks are. The concern with insurers--life insurers especially--is a sustained period of low interest rates.

RD: And funds play out pretty much the same way as asset managers?

Dhru: It is highly dependent on the evolution of the European sovereign crisis because a lot of the funds actually hold European bank debt. Also, additional regulation for money market funds in the U.S. could be a challenge. So with performance and performance fees under pressure, money market funds will need to pay closer attention to reducing operating costs. At the same time, many fund companies may seek to offer alternative investments as well.

RD: What are the key credit risks in the corporate sector at this time?

John Bilardello: Over the last couple of years, corporations have exhibited discipline at cutting costs and managing the balance sheet. In that environment, we've actually had more upgrades than downgrades in nearly every month since the summer of 2009. And 70% to 75% of our ratings outlooks are stable. The balance between negative and positive outlooks is also fairly even.

The key factors that we're actually watching are very macroeconomic. The growth of economies around the world is one thing. Another is the level of unemployment and the resulting impact on consumer spending, which is also affected by declining or weak real estate prices and fluctuating equity values. The last thing we're watching is the impact of the European economy and whether that has contagion effects around the world, whether through lower growth or constrained liquidity.

With those being the key factors, companies actually execute fairly reasonably in a slow-growth environment, especially when they're exhibiting the discipline in cost control they're exhibiting now. Under those conditions, we would anticipate a continuation of the balanced ratings activity that we see today.

If the eurozone economy worsens and it results in some sort of contagion or affects global liquidity, that would be a much more negative environment. We certainly would expect to see more downgrades of corporate issuers around the world as liquidity dries up and a much greater number of negative outlooks.

RD: Are there any industries that seem poised to show increased credit strength in 2012?

Bilardello: Manufacturing companies actually have done very well over the past couple of years, and their financial performance has improved. But the manufacturing sectors that we follow today have generally used their free capacity and now require a stronger economy to see their financial performance improve.

Similarly, many of the consumer sectors--particularly the discretionary sectors such as retail and leisure--are going to struggle in a slow growth environment. They're going to struggle when the consumer is not spending robustly. I would say the consumer discretionary areas are where we have the most concern.

The sectors that may show some strength are the commodity sectors. Commodity prices are hovering at relatively high levels and don't seem to be coming down at the moment. But they do tend to move very quickly. And when they move very quickly, that causes havoc on the ratings of companies in all commodities, whether they be agricultural, oil, metals, etc.

RD: In general, no matter where they are on the rating scale, most corporations have been able to successfully refinance their maturities. What are the prospects for 2012?

Bilardello: I would say, given the last two months, that we've seen signs that refinancing activities will continue in 2012. Interest rates are still very low, certainly for investment-grade issuers, and they're reasonable for speculative-grade issuers.

In the scenario where we just have a slow growth environment with no extraordinary circumstances, I would expect that to continue. There's still close to $2 trillion of U.S. corporate debt coming due over the next five years. But the peak from 2014 has come down and has basically pushed out to 2015-2016. Of that $2 trillion coming due in the U.S. and $1.5 trillion coming due in Europe, half in the U.S. is investment grade and more than 80% of what's coming due in Europe is investment grade. The risk is higher for speculative-grade issuers, including those rated 'B' and below, given the economy in Europe, but for investment-grade companies, we would expect refinancing to occur.

RD: What are companies doing and what do they plan to do with the historical levels of cash they are currently carrying on their balance sheets?

Bilardello: Corporations have exhibited great discipline at cutting back on expenditures and managing cash and building up those cash balances. In the U.S., there's $1.5 trillion of cash sitting on the books of corporates. That's up by $300 billion or $400 billion--a pretty significant rise over the last three years.

The question is, do they have the patience to maintain that discipline? In our experience, this sort of discipline doesn't last forever. We expect those cash balances to come down and companies to start using it toward acquisitions or stock buybacks. We would not expect corporations to use that cash on debt reduction.

RD: Won't they end up spending a lot of that because they need to improve their share prices by adopting more aggressive growth strategies?

Bilardello: That is exactly why we don't expect them to maintain this kind of discipline in the slow growth environment that we're seeing today. You have to remember where their incentives are: to satisfy their equity holders. They need to improve their financial performance, and in a slow growth environment there's only so much they can do. That's why we don't anticipate the discipline lasting forever, and we do anticipate acquisitions to occur.

I would expect the private equity firms to be more aggressive in this period, as equity values seem to be relatively high. Liquidity and interest rates are relatively low so I would expect a lot of activity coming out of private equity firms.

RD: Do you think these acquisitions and mergers would largely be strategic?

Bilardello: I think it'd be a pretty good mix. The opportunity for strategic mergers and acquisitions exists right now. But once the private equity firms get involved, that pretty much crowds out the strategic acquisition.

RD: Tax receipts have not been keeping pace with state budgets and, in general, the political climate seems to favor spending cuts over increasing revenues. Do we expect continued cutting of public sector jobs through next year?

Bill Montrone: The period that we've just come through has been very challenging. Some would argue that we're still in the middle of it. But if you look at how the public finance sector has responded, for the most part what we've seen are spending cuts, reducing reserves, postponing both discretionary as well as capital outlays. Nothing underscores this more than the reduction in the size of the municipal market this year by over 35% from where it was in 2010. We've seen significant reductions in public employee payrolls, mainly through attrition, which can be a very powerful tool that governments use.

I think the bottom line here is you have to act. The problems are very clear. For those governments that have acted, credit quality has remained stable. And what we would expect going forward--regardless of the economic situation that presents itself for those that continue to try to align resources with expenditures--is that credit quality should remain relatively stable. Let's not forget that, for the most part, governments, states, and large local governments have wide flexibility in how they manage themselves.

The U.S. Budget Control Act of 2011 comes into play here because the Super Committee failed to act. It completely punted. That triggers an immediate $1.2 trillion in federal spending reductions coming in the first of the year. So the prospects for intergovernmental transfers have dimmed even further at this point.

RD: Do you expect that the lower tax revenues will generate negative rating actions for smaller jurisdictions, as well as for the major states and cities, this year?

Montrone: If you look at asset devaluations here, obviously incomes are down which is translating into lower sales taxes. Property values are down. But local governments generally have less reliance on state and federal sources to pay for their own expenses. From that standpoint, they also have increased flexibility to deal with declining property values. So this has less of an impact on the local government sector, generally speaking, particularly since pension costs, health care costs, some of the entitlement programs that burden the federal as well as the state governments, are not so severe at the local government level.

RD: With the states having some financial troubles, are we seeing any growth in the movement toward public-private partnerships for infrastructure projects next year?

Montrone: It's funny, but we're seeing none whatsoever. I think what has gotten in the way of public-private partnerships is that when there was a big push early on to do this, with many governments entering into large and significant transactions three to five years ago, they ended up using the proceeds in a way that the taxpayers didn't like. They ended up plugging budget holes and using them for one shot expenditures rather than putting them into the asset base of the community. I think that turned a lot of taxpayers and voters off to public-private partnerships. When that happens, it turns the politicians off as well. So we really haven't seen a rekindling of that sector in the last couple of years.

RD: What's our 2012 outlook for the creditworthiness of the structured finance sector?

Howard Esaki: I think the economic forecasts are for moderate growth next year, so we expect stability in credit for most U.S. structured finance products. In Europe, there may be some problems based on the economic slowdown there, but generally in the U.S., we expect stable to slightly improving conditions.

RD: What are the key credit risks right now for structured finance?

Esaki: The housing market still has a lot of uncertainties about it, and that has historically been the largest sector. So that's going to be key. In CMBS [commercial mortgage-backed securities], the recovery of the commercial real estate market, which was quite robust early in 2011, slowed a little bit. That presents some challenges in 2012. For consumer ABS [asset-backed securities], I think if the economy continues to grow modestly, we'll see modest improvement in consumer balance sheets as well.

I don't think the European debt crisis will have a direct impact on U.S. structured finance. Obviously, it will have an impact on European outstanding issues, but in the U.S. the effect would be through the effect on economic growth. If economic growth slows, then that would have a follow-on effect on structure finance, but no direct impact.

RD: What do we project will be the strongest and weakest segments of the structured finance market in 2012?

Esaki: In terms of issuance, ABS will probably continue to be relatively strong. This year it was the dominant source of new issuance in the U.S., and we think that will continue next year. It's been about $15 billion a month on average, so it was by far the most prolific in issuance. In Europe, we expect some sectors like the German auto space and U.K. prime RMBS [residential mortgage-backed securities] and Dutch RMBS to also be strong. Generally, overall, we expect all sectors to be stable to somewhat improving.

RD: Are there any sectors, in particular, of U.S. ABS that you think are going to pick up?

Esaki: Auto ABS in the U.S. has been strong. We expect that strength to continue next year if auto sales continue at the pace we've seen in the past couple of months. Other than autos, there's been a little bit of a revival in credit card issuance, some increases in student loans, and also about $10 billion or so in so-called nontraditional assets--things like timeshares or franchises. There was a deal done late in 2011 backed by movie rights, so we could see other deals of this nature.

RD: CMBS seemed poised for a strong year in 2011. What happened? And what is the outlook for CMBS in 2012?

Esaki: It was a little disappointing. We had projected total issuance, at the beginning of 2011, of about $35 billion. It's probably going to come in around $31 billion. So it's not too far from what we initially expected. But there was a notable slowdown in the second half, caused by the volatility over the summer, and spreads were increasing so dealers didn't want to take on the risk of originating loans. Origination of loans slowed in the summer, and since it takes three to six months to accumulate loans into CMBS, we've seen a slowdown in the last quarter of 2011, probably extending into 2012.

Having said that, market participants are starting to become a little more optimistic about loan originations. Our forecasts for 2012 are about flat compared with 2011, maybe a little bit less, but around $30 billion to $35 billion in issuance. That's in the U.S. In Europe there probably will be very little CMBS issuance. There was practically nothing this year. I think there was one deal and it will be very low next year.

RD: With private label RMBS out of commission, do you see a good chance that 2012 will be the year that covered bond legislation is passed in the U.S.?

Esaki: We do agree that there will be an extremely small amount of RMBS issuance in 2012. Nothing's really going to happen with GSE [government-sponsored entities] reform in our view until after the election, and it will probably take significant time for the enactment of major changes to the housing finance system. So there won't be much on the non-agency RMBS front in the U.S. in the near future.

As far as covered bonds, there are mixed opinions. Our analysts both here in the U.S. and in Europe are split in their opinions. Some think there's a good chance, some think there's no chance of U.S. covered bond legislation passing. But there is a bill in front of the Senate now, so over the next couple of months, we'll get more clarity on that. My view is that probably nothing will happen until after the next election.

Covered bonds would certainly add another source of funding for commercial and residential mortgages. I think it would add to issuance. I know the FDIC [Federal Deposit Insurance Corp.] is opposed because they don't want to ring fence these assets in case of a financial institution insolvency, so they're the main party opposing it.

RD: What's the outlook for CLOs?

Esaki: For CLOs [collateralized loan obligations], we expect a modest increase in issuance. For 2011, we will probably have about $12 billion. We expect about $15 billion next year. That's big growth in percentage terms, but it's small relative to historical issuance. We expect stable credit, with levered loan default rates near record lows.

RD: How do you feel about structured finance as we head into 2012?

Esaki: I think it's still valuable as an alternative source of funding. It's not going to be such a dominant sector as it was in 2007, for example, for residential mortgages. I think there's a place for it in the world of financing of these assets, but it's not going to play as major a role as it did previously for many years.

RD: Some say structured finance turned out not to be effective as a risk transfer mechanism. Do you think that it could still function in this way?

Esaki: I disagree a little bit with the premise of that because risk did get transferred. It was borne by the ultimate investors in the securities. I think there are a lot of regulatory challenges now, so it's probably not going to return to the place it was a few years ago, but I think it will show slow and steady growth over the next few years.

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