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RISK HEADQUARTERS

FEBRUARY 2023

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MACRO-CREDIT ENVIRONMENT OVERVIEW

CONSENSUS: RECESSION IS A GIVEN

- There were glimmers of positivity from 4Q22 data with headline inflation coming down, Europe averting a full-blown gas shortage and developed market employment holding up.
- However, the established consensus remains that recessions in 2023 are inevitable. Inflation will not fall without negative effects on consumption and investment through the monetary policy channel.

CHINA'S END TO ZERO-COVID POLICY IS A GAME CHANGER

- China's sudden and surprise end to its long-held zero-Covid policy is a game changer. Over a two-year horizon, this is clearly positive for consumer spending and will mean a more rapid economic recovery from this year.
- However, the epidemiological impact over the short term remains highly uncertain and could dampen growth further in 1Q23. Risks from the prolonged property slump could yet dampen the consumer recovery.

INFLATION, FINANCIAL CONDITIONS REMAIN KEY RISKS

- Macro-related credit risks that have been building since the rate-rising cycle began in 2022 remain. As Fitch Ratings outlined in several **2023 Outlook reports**, the main risk to vulnerable sectors from higher inflation and related financial tightening remains.
- Ratings Outlooks across our global portfolio, which are predicated on our macroeconomic base case, remain overwhelmingly Stable. However, almost half of our sector outlooks, which evaluate broader operating and macro conditions, are 'deteriorating'. Deterioration beyond our current assumptions would risk a greater negative rating effect.

WHAT IF THE COST OF CAPITAL HAS STRUCTURALLY SHIFTED HIGHER?

- A significant challenge to forecasting and understanding plausible risk scenarios are potential deeper structural shifts in the global economy. These include a structural shift higher in inflation and nominal interest rates, the sustained rise of geopolitical risk and "geo-economics", and domestic political polarisation.
- If the inflationary and monetary environment that has emerged over the past year represents an end to the decades-long low-inflation and easy monetary policy environment, this could mark a fundamental shift for credit risk. It would signal a more prolonged period of risk for everything from property markets, the cost of capital, debt sustainability and long-term economic growth rates.

WHAT IF THERE IS NOT A QUICK RETREAT TO PRE-PANDEMIC INFLATION RATES?

- Inflation is still the key global "what-to-watch" item. Sustained downside inflation surprises will increase the possibility of an end, or even a pivot to reverse monetary policy tightening.
- But this is by no means certain. Central bank responses are difficult to predict, especially given the volatile political climate. Labour markets could yet stay unexpectedly resilient while the return of the Chinese consumer to the global economy could spark a renewal of upward commodity price pressure, prompting a higher-rates-for-longer scenario and deeper or more prolonged recessions.

WHAT IF WE ARE IN A NEW ERA OF 'GEO-ECONOMIC' COMPETITION?

- The Russia-Ukraine war is a marker of a broader shift in the geopolitical order that materialised after the end of the Cold War. While the term "geo-economics" was coined in 1990, it has become increasingly common in macro and market assessments, and is reflected in sustained tensions between China and the US.
- Trade liberalisation over the past 30 years has been both a driver of global growth and a factor in pushing the real costs of goods down. A reversion to increased national industrial strategies and geopolitically driven economic policy decisions would reduce growth potential and affect certain sectors with potential credit implications over the long term.

KEY TAKEAWAYS

1. **The scale and pace of disinflation and the accompanying monetary policy response in 2023 is a key watch item for broader macro risk.**
2. **A long-term shift higher in the cost of capital would mark a more structural as opposed to cyclical credit risk.**
3. **The rise of geo-economics and geopolitical risk could reverse decades of trade liberalisation, adding to long-term growth challenges.**

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KEY RISKS: FEBRUARY 2023

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

The update for 1Q23 focuses on inflation as the main what-to-watch item that is likely to determine the pace of a post-recession recovery. We are also highlighting potential structural macro shifts in the cost of capital and geopolitics. China macro remains a major uncertainty, though the end of Zero-Covid has clear positive demand effects.

COST OF CAPITAL, DEBT AND FINANCIAL INSTABILITY

Rising nominal and real interest rates continue to create the conditions in which hidden leverage and financial vulnerabilities will be revealed. The probabilities of a financial shock in an asset class or sector where increased default levels catalyse an unwind in leverage remain elevated. Risks are also accentuated should property price contractions in the main developed markets, shaky investor confidence and a lacklustre real economy surprise to the downside from consensus.

CHINA MACRO ENVIRONMENT

The lifting of China's zero-Covid policies is a fundamental change. While likely to be positive for growth over a 12- to 24-month horizon, the rapid spread of infection raises significant uncertainty in the short term. The state of the property sector is also highly uncertain and a weak performance could dampen the consumer-led recovery. A weak bounce-back in the property sector would put strains on medium-term growth, China's public finances and financial system with implications affecting the outlooks for APAC and the wider world. Should China's recovery be on the strong side of expectations, it will be inflationary for the global economy, adding pressures to global energy prices in 2H23.

INFLATION

Inflation stays above consensus expectations, negating the likelihood of a monetary policy pivot further into 2024. This exacerbates the macroeconomic and political pressures from higher costs of living, higher costs of capital, and tensions between monetary and economic policies, all of which would raise the risks of deeper recessions and delayed recoveries.

GEOPOLITICS, GOVERNANCE AND POLICY RISKS

Risks from policy mis-steps resulting from sustained high inflation and political pressures drive tensions between monetary and fiscal policy threatening financial stability and prolonging macroeconomic underperformance. The inflationary and weak growth environment exacerbate deep domestic political divisions, which in turn undermines policy formation and elevates the risks from elevated sovereign debt in certain countries. Heightened geopolitical risk remains a core tail risk. Notable watch points include the Russia-Ukraine war and tensions in the Taiwan Strait as well as the broader implications of geo-economic policy shifts.

CLIMATE TRANSITION

Changing regulatory requirements, consumption trends, disruption from physical climate change effects and investor-driven 'green' capital allocation decisions pressure issuers to adopt more sustainable operating models and affect valuations for key asset classes, such as housing. This results in increased revenue volatility and capital costs/refinancing risks for the most exposed entities.

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INFLATION

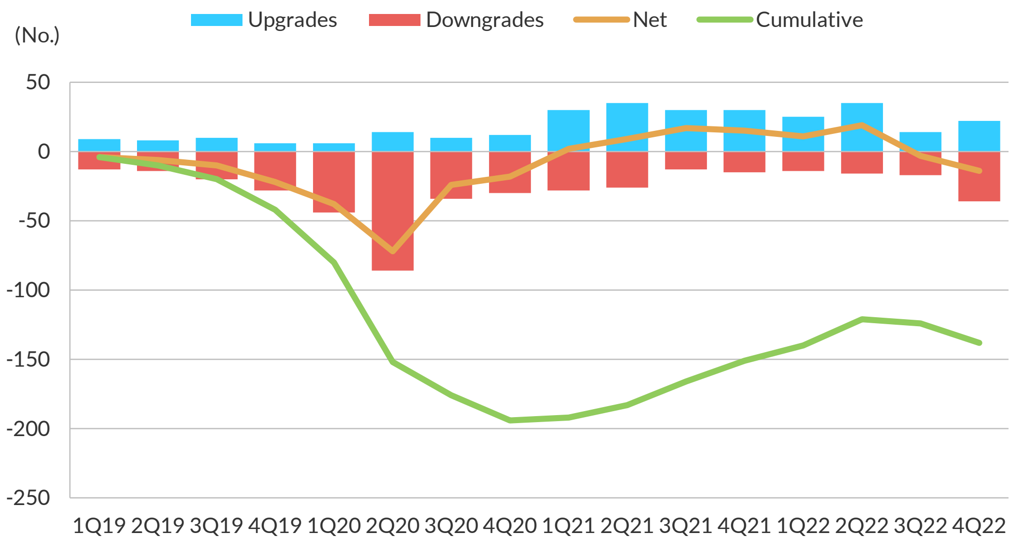
KEY DEVELOPMENTS

- **Headline annual inflation rates in both the US and the eurozone fell back from their 2022 peaks, in line with our expectations for moderated price growth this year.**
- **Central bank signals remain focused on inflationary pressures, especially in the EU, where the ECB raised its 2023 core and headline inflation forecasts.**
- **In the US, the Federal Reserve has acknowledged that inflationary pressures have eased and reduced its latest rate rise to 25bp from 50bp previously. However, it has also continued to flag that inflation may exceed its expectations, especially if wage and services price pressures remain elevated.**

NOTABLE CREDIT AND RATINGS RESEARCH

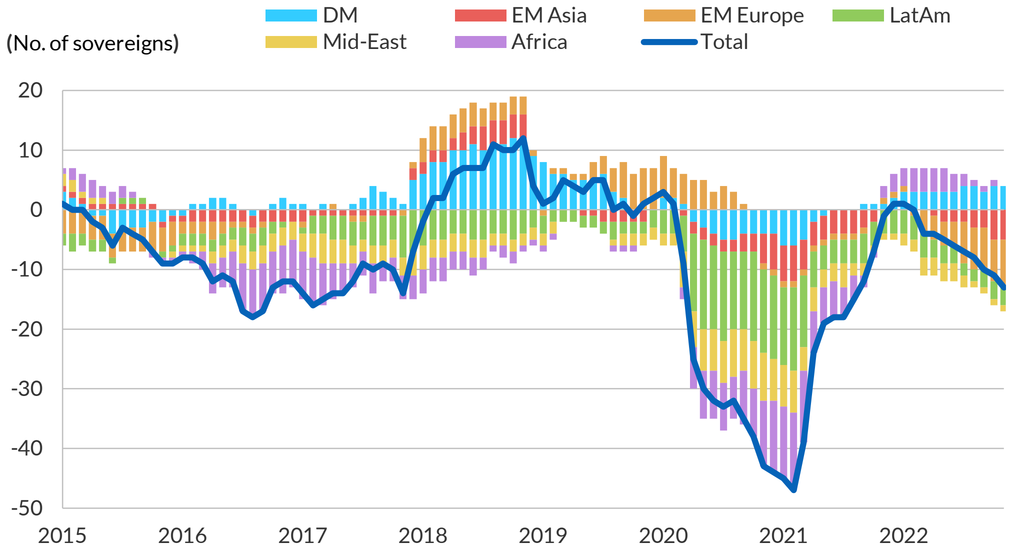
- **Global financial institution downgrades still outpaced upgrades in 4Q22**. Weakening financial performance and profitability, lower capitalisation/higher leverage were frequent drivers of negative actions. Persistently high inflation is also challenging all financial institutions by raising operating expenses.
- Downgrades exceeded upgrades in both **North America** and **developed EMEA non-financial corporates** in 4Q22. We expect downgrades to continue to exceed upgrades in North American corporates owing to slowing growth, high inflation and rising interest rates. In Europe, a modest increase in Negative Outlooks underscores the risks from waning demand, increasing input costs and higher rates.
- **'Deteriorating' sovereign sector outlooks reflect weaker global economic growth, rising funding costs and pressures from high inflation**. The early fiscal benefit from inflation on government revenues and nominal growth will fade as spending pressures mount as higher rates push up debt service costs.
- **Persistent inflation and continuing cost pressures** are factors contributing to 'deteriorating' sector outlooks for six of eight US public finance sectors.

North American Corporates Upgrades/Downgrades by Quarter



Source: Fitch Ratings

Sovereigns Net 12-Month Trailing Rating Changes



Source: Fitch Ratings

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COST OF CAPITAL, DEBT AND FINANCIAL INSTABILITY

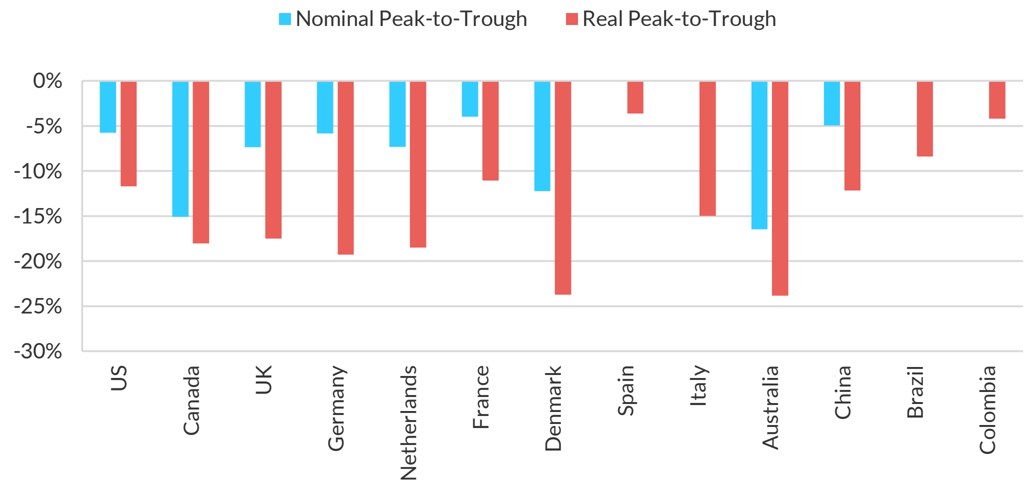
KEY DEVELOPMENTS

- The Fed raised its policy rate by a cumulative 150bp at its November, December and February meetings while the figure for the ECB was 100bp over the same period. The ECB signalled that 50bp increases are likely to continue over the short term, whereas the Fed reduced its rise to 25bp in February.
- Housing market indicators in developed countries continued to slow with US existing home sales falling below the recent nadir at the beginning of the pandemic.
- Global investment bank 4Q22 earnings reported sharp drops in profits as a result of contractions in deal-making and markdowns in equity holdings.
- Severe currency pressures have spread to Pakistan and Egypt over the past quarter.

NOTABLE CREDIT AND RATINGS RESEARCH

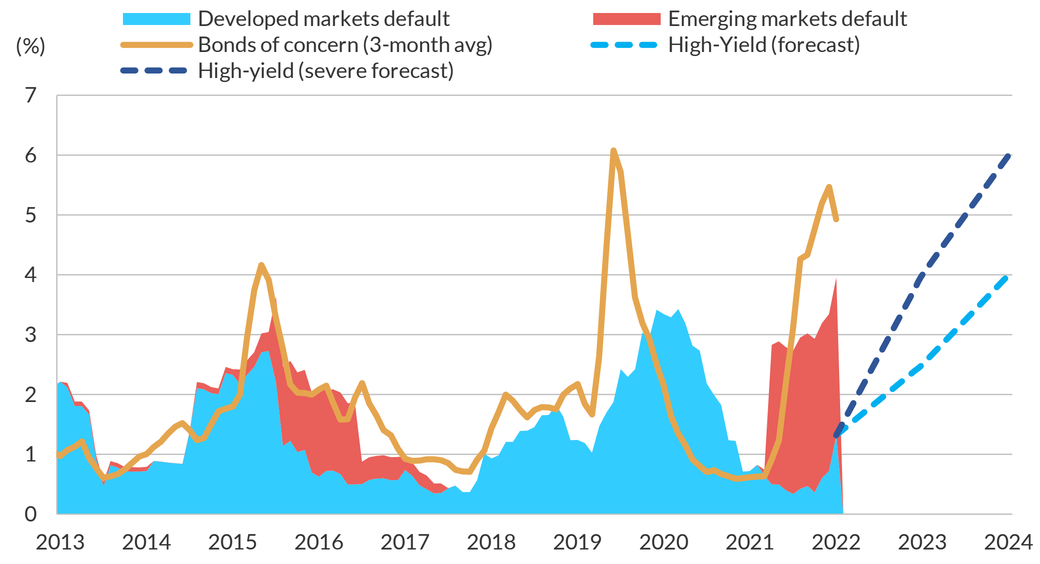
- We **raised our forecast for ECB policy rates** and now expect 150bp in cumulative increases this year.
- Asset performance across several structured finance sectors in **Europe** and **North America** is likely to deteriorate this year. However, rating Outlooks are overwhelmingly Stable, reflecting credit enhancement and structural protection for rated notes.
- **Fiscal risks to eurozone sovereigns** from the energy crisis will persist in 2023 although these will be highly dependent on wholesale gas prices and demand.
- **The risk of further monetary policy adjustments in Japan have increased, raising risks to Japan's public debt trajectory**. High public debt remains Japan's key rating weakness.
- Nominal home price growth will decline or slow substantially in most markets assessed in our **Global Housing and Mortgage Outlook**.
- **EMEA high-yield bond and leverage loan markets are likely to see rising default rates and net downgrades in 2023**.
- We have **increased our 2023 US high-yield default rate forecast** to 3.0%-3.5% as a result of macro headwinds.

Peak-to-Trough Home Price Forecast in Nominal and Real Terms



Note: Based on middle of forecast ranges. Peak between 3Q21 and 4Q22
No real or nominal home price decline: Mexico, Japan. Only negative real HPD: Italy, Spain, Brazil, Colombia
Source: Fitch Ratings, OECD, Haver Analytics, CoreLogic AU, TER/NBC, DKstat, CBS, HMLR, Bulwien, Case-Shiller, CNBC, INSEE, ScenImm/ISTAT, INE, JHFA, DANE, FIPE, SHF

EMEA High-Yield Bonds



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GEOPOLITICS, GOVERNANCE AND POLICY RISKS

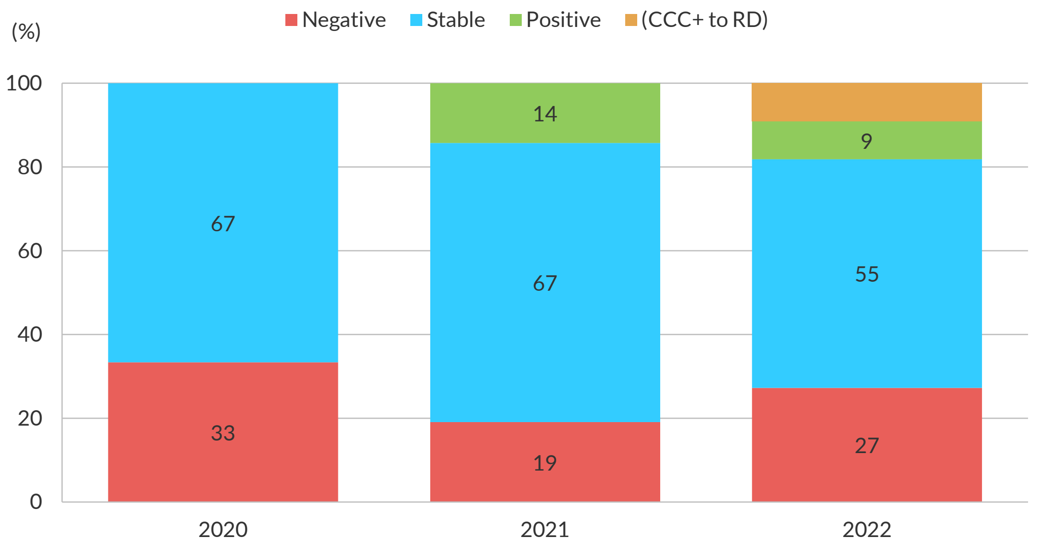
KEY DEVELOPMENTS

- **Political wrangling over raising the US debt ceiling re-emerged with the new Republican majority in the House of Representatives. There is significant uncertainty as to the "X-date" when the federal government would run out of cash, but failure to raise the limit in time to avoid an outright default could have significant short-term consequences.**
- **Japan and the Netherlands joined a prior US initiative to restrict the export of chip-making equipment to China further underscoring the growing relevance of geo-economic policymaking for this sector.**
- **The Russia-Ukraine war continued over the last quarter with no sign of abatement.**

NOTABLE CREDIT AND RATINGS RESEARCH

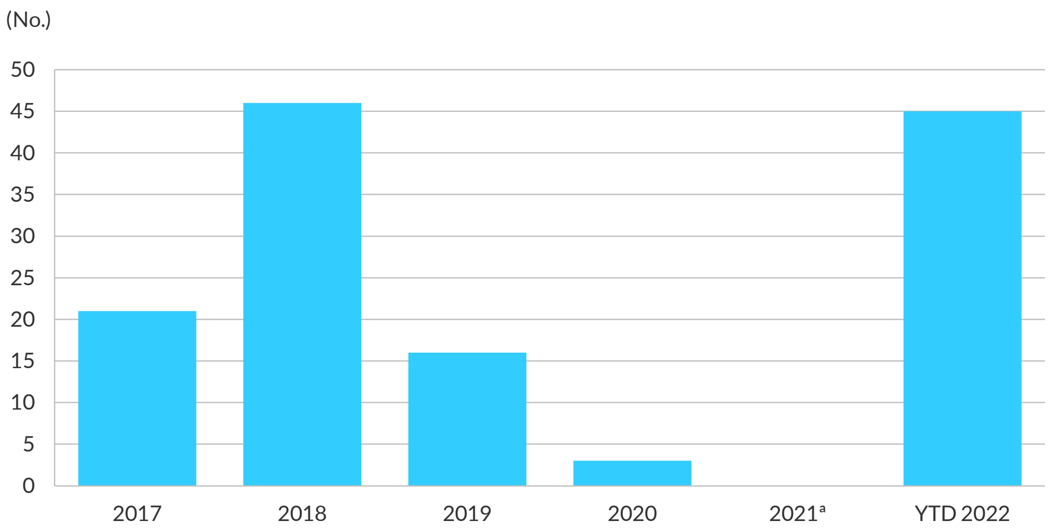
- **The US and China have entered a period of strategic competition** where disagreements have broadened into multiple areas of the bilateral relationship including core issues on national security and strategic alliances. A sharp unravelling of economic ties, for example, due to a military confrontation in the Taiwan Strait, would result in a catastrophic global supply shock, although this remains outside our base-case expectations.
- The war in Ukraine and uncertain energy supply continue to underpin **worsening credit conditions for emerging European sovereigns in 2023**.
- **The divided government result of the US mid-term elections raises the possibility that scenarios potentially triggering negative rating sensitivities may play out**. These sensitivities include a significant sustained rise in general government debt/ GDP and a deterioration in governance quality leading to protracted government shutdowns, failures to increase the debt ceiling limit in a timely fashion or a decline in the credibility of policymaking that undermines the dollar's reserve currency statues.
- Heightened political risk in several major emerging markets are having effects on their economic outlooks, including in **Peru**, **South Africa**, **Turkey** and **Chile**.

Emerging Europe - Rating Outlooks



Note: Ratings 'CCC+' and below do not have an outlook
Source: Fitch Ratings

Turkish Banks – Rating Downgrades



[a]No rating downgrades took place over this period
Source: Fitch Ratings

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CHINA MACRO

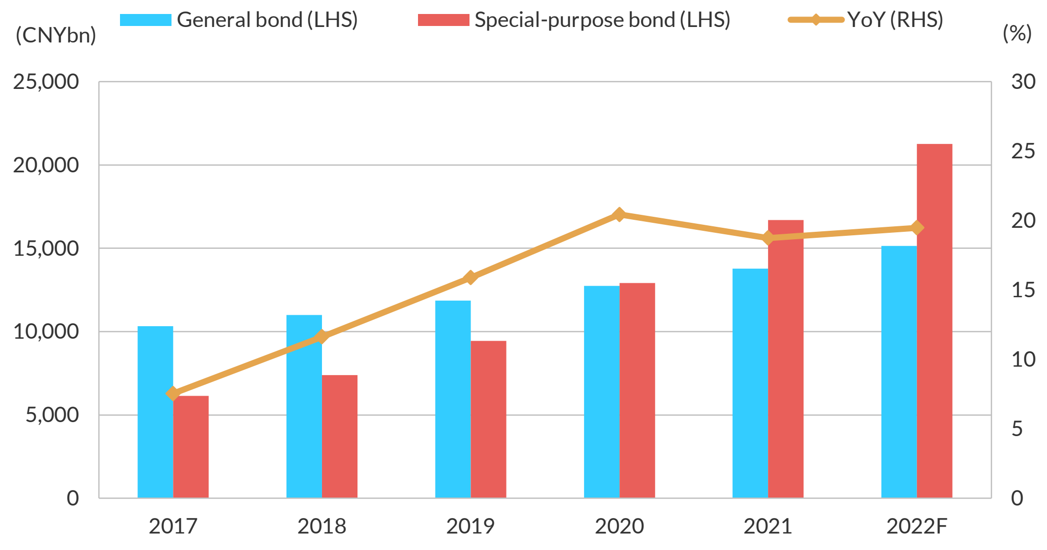
KEY DEVELOPMENTS

- **The abandonment of Zero-Covid is a significant policy change that will have a material positive effect on China's 2023 and 2024 macroeconomic outlook.**
- **A more rapid consumption-led recovery is now likely to result in stronger top-line economic growth rates over this year and next.**
- **The return of the Chinese consumer in force raises the risks of a net inflationary effect on the world economy as demand rises faster than supply, especially in global commodity markets.**
- **A key unknown remains property sector policies. Some loosening has already taken place, but a rapid rebound in construction and housing sector activity may require a more wholesale easing.**

NOTABLE CREDIT AND RATINGS RESEARCH

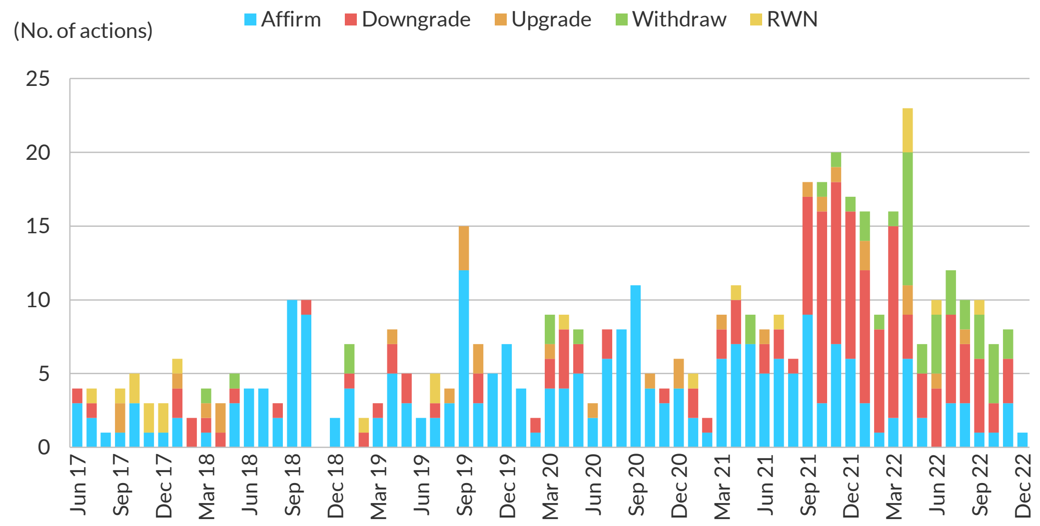
- **Chinese homebuilders still accounted for four of nine non-financial corporate downgrades in APAC** in the fourth quarter, but this was the lowest quarterly number of downgrades since 1Q21.
- **China's local government financing vehicle (LGFV) sector should see increasing polarization in financing access and support in 2023** stemming from fiscal pressure faced by local and regional governments. There may be paced debt restructurings of **LGFVs in weaker regions** as authorities explore options to resolve looming default risks.
- **Multiple sectors in China face rising headwinds should lingering property stress** drag on and not respond to policy support measures. **Relaxed funding policies will boost liquidity buffers for stronger developers** but a sustainable recovery still hinges on a more long-term restoration of housing demand which will depend on the pace and scale of income growth amid an expected post-Covid recovery.
- The lifting of China's Zero-Covid policy will have a net positive effect on several sectors over the next 12-24 months as consumption-driven demand recovers. **High-frequency data have already shown a recovery in commuter traffic and logistics**. **Regional tourism**, the **retail sector**, logistics and **transport**, and **international air travel** are all likely to see benefits in 2023.

Local Government Direct Debt



Source: Fitch Ratings, MoF

Fitch's Rating Actions on Chinese Property Developers



Note: The latest month as of the day before publication
Source: Fitch Ratings

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CLIMATE TRANSITION

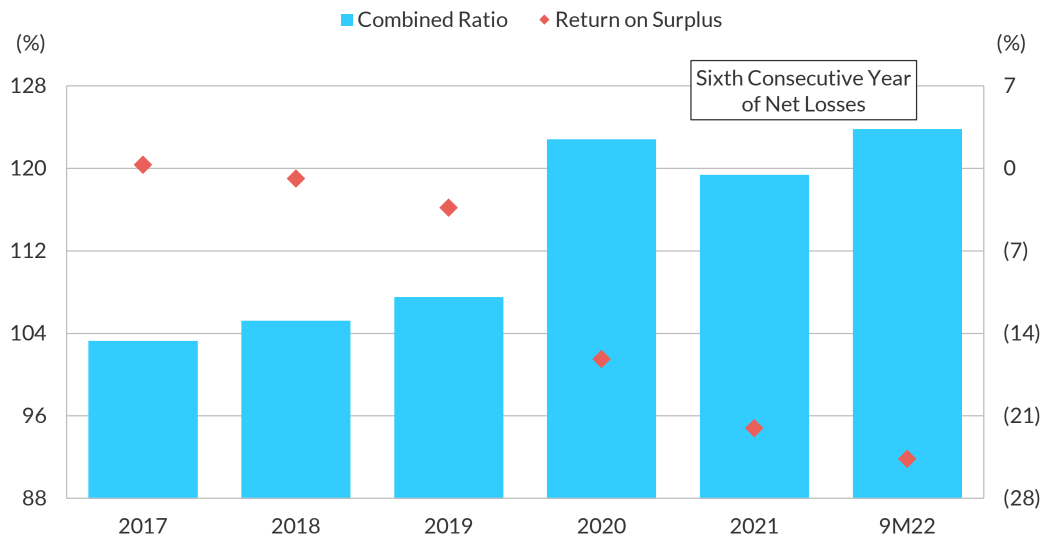
KEY DEVELOPMENTS

- European officials announced plans to respond to US carbon transition subsidies that were passed as part of the USD369 billion Inflation Reduction Act. Proposed measures include easing tax credits and state-aid rules to companies in the renewable energy sector.
- Political backlash against financial institutions' ESG-oriented investment policies is emerging in the new US Congress.

NOTABLE CREDIT AND RATINGS RESEARCH

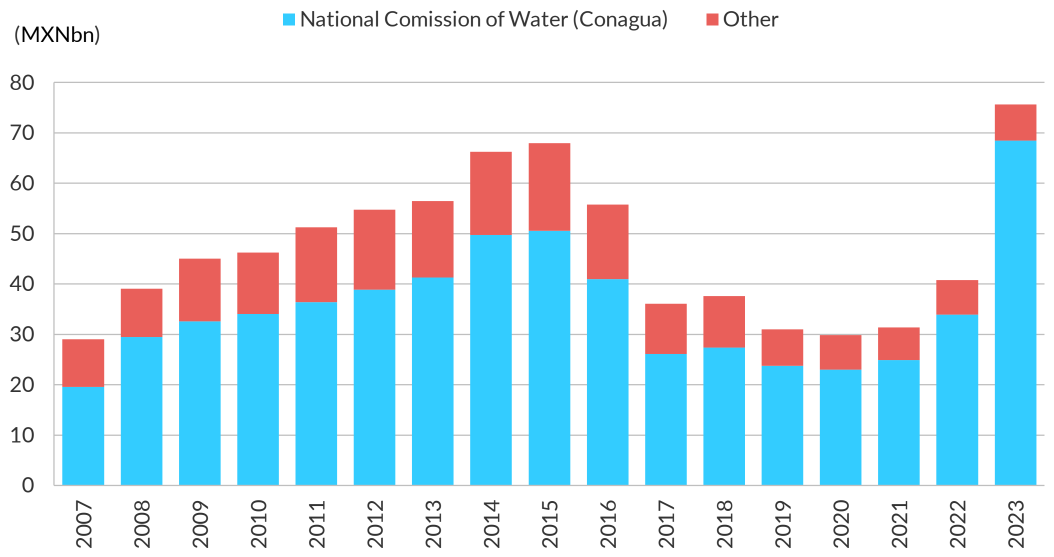
- Hurricane Ian-related losses could lead to further market exits by **Florida homeowners' insurers amid capital concerns and reinsurance market challenges**. A lack of homeowners coverage availability could in turn negatively affect Florida's real estate, mortgage and labour markets.
- State and federal disaster relief funds have largely mitigated the financial effects of weather-related events on Fitch-rated local governments in California. However, **local government credit quality could be affected** should state and federal disaster support be reduced and local resources become insufficient.
- **Fitch rated its first sovereign bond with a natural disaster clause**, assigning a rating of 'B' to Barbados' US dollar-denominated global bonds maturing on 1 October 2029.
- **Droughts and floods have implications for the creditworthiness of Mexican water utilities** though the direct impact is as yet difficult to quantify. Federal support will be key, given increased contingencies due to water shortages.

Florida Homeowners' Specialists Statutory Performance



Note: Results aggregated for 24 Florida specialist homeowner groups statutory accounting
Source: Fitch Ratings, S&P Global Market Intelligence

Mexico: Budgeted Funds – Environment and Natural Resources



Source: Fitch Ratings, Ministry of Finance

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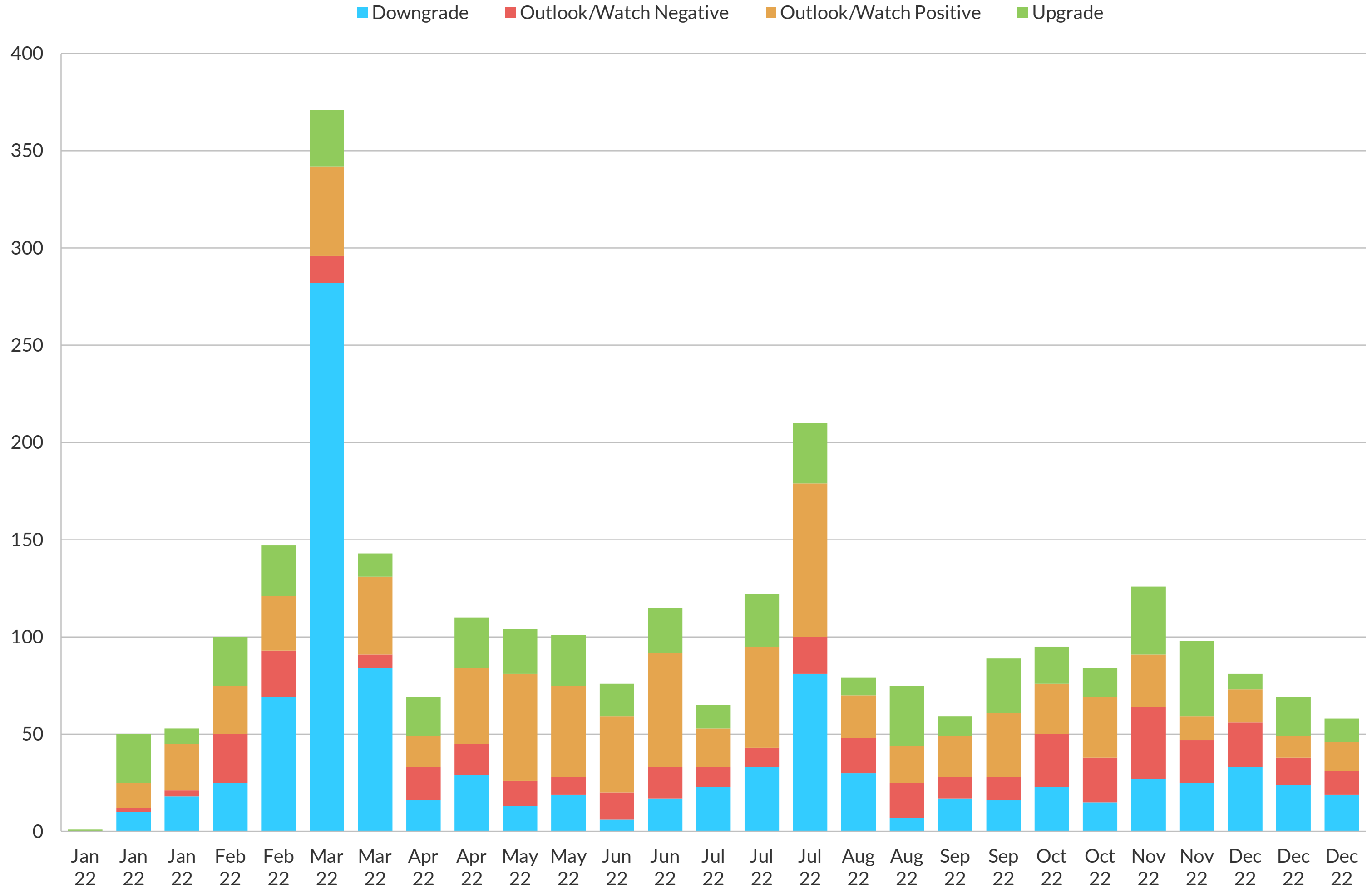
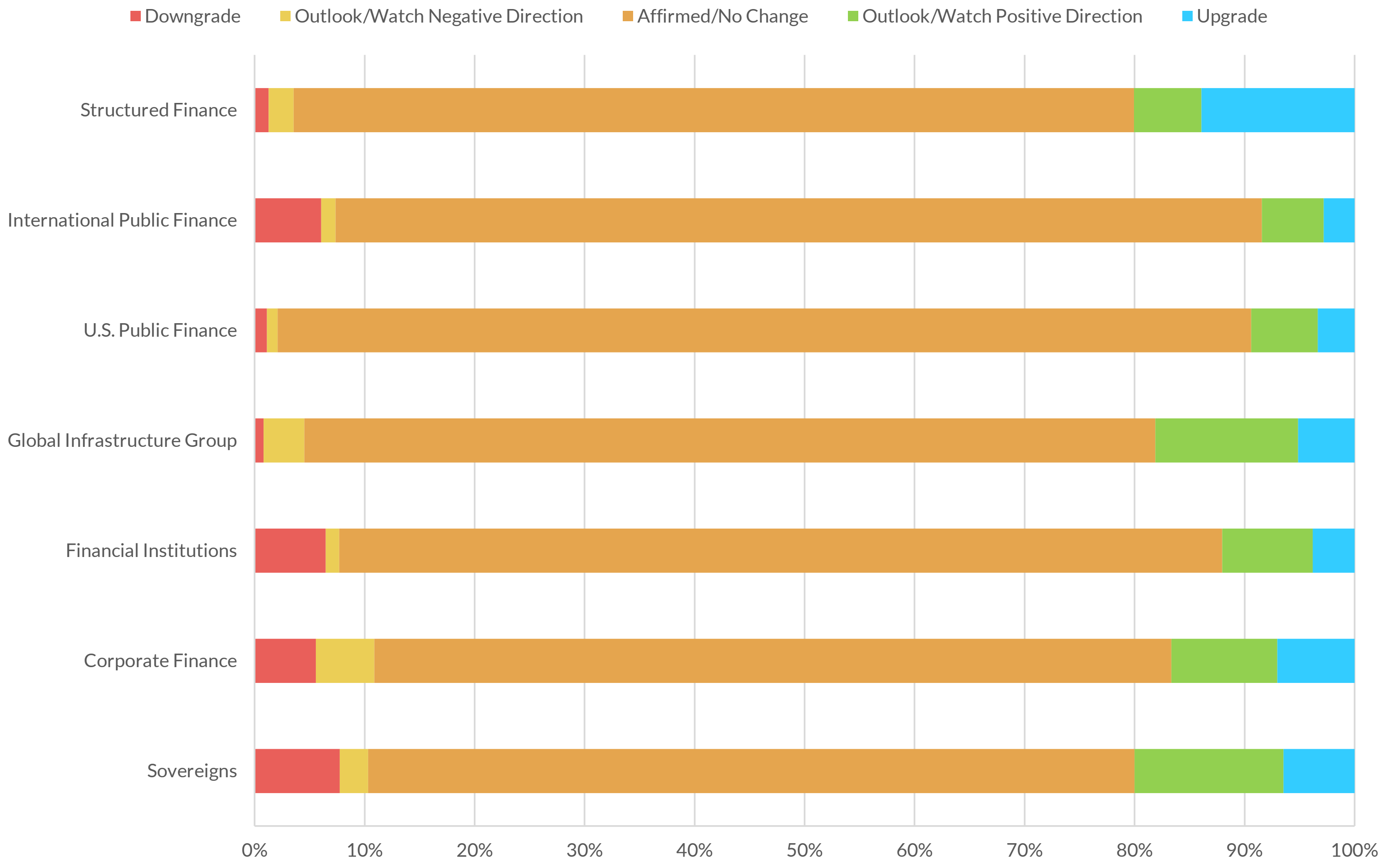
RATINGS PERFORMANCE

2022 Bi-Weekly Breakdown of Fitch Rating Actions (Excludes Structured Finance)



Source: Fitch Ratings

Ratings Snapshot Analysis by Change over 2022



Source: Fitch Ratings

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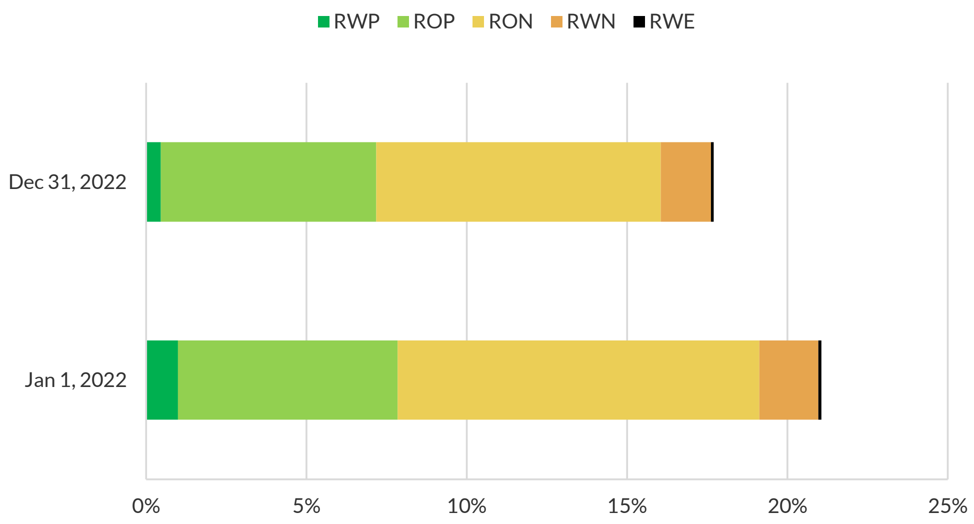
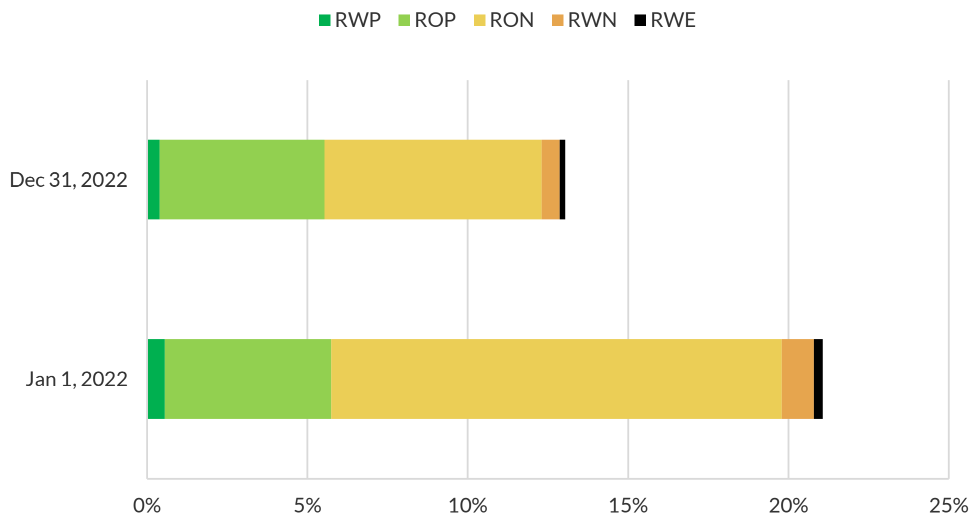
RATINGS SNAPSHOT: PERCENTAGE OUTLOOK/WATCH DISTRIBUTION BY GROUP (GLOBAL)

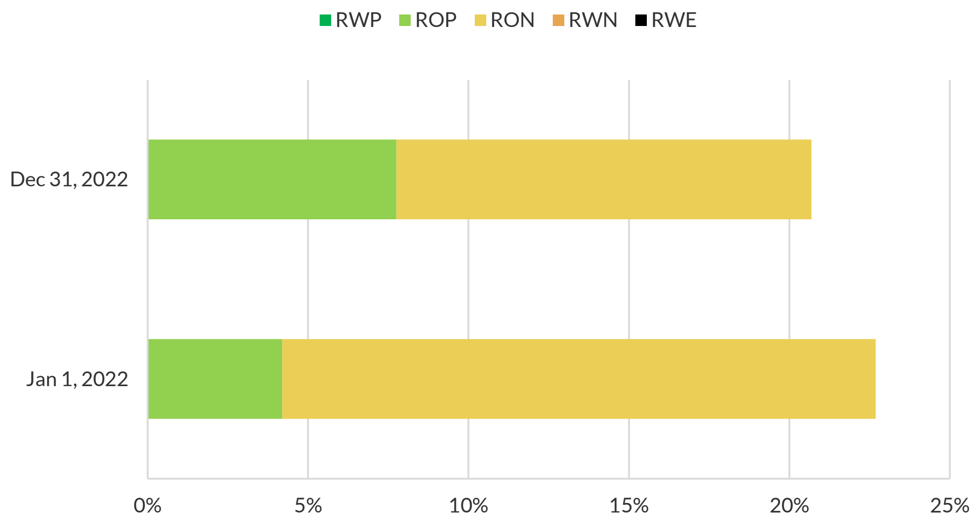
Corporates



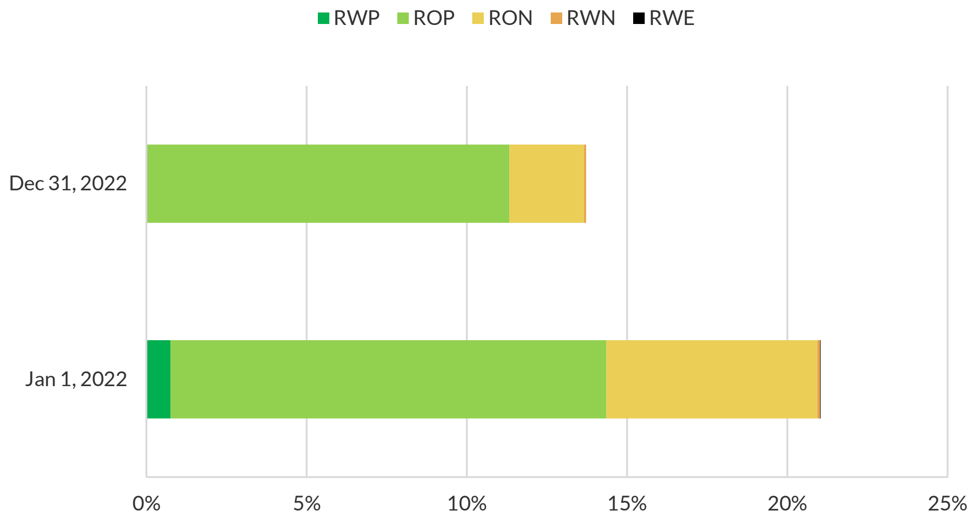
Financial Institutions



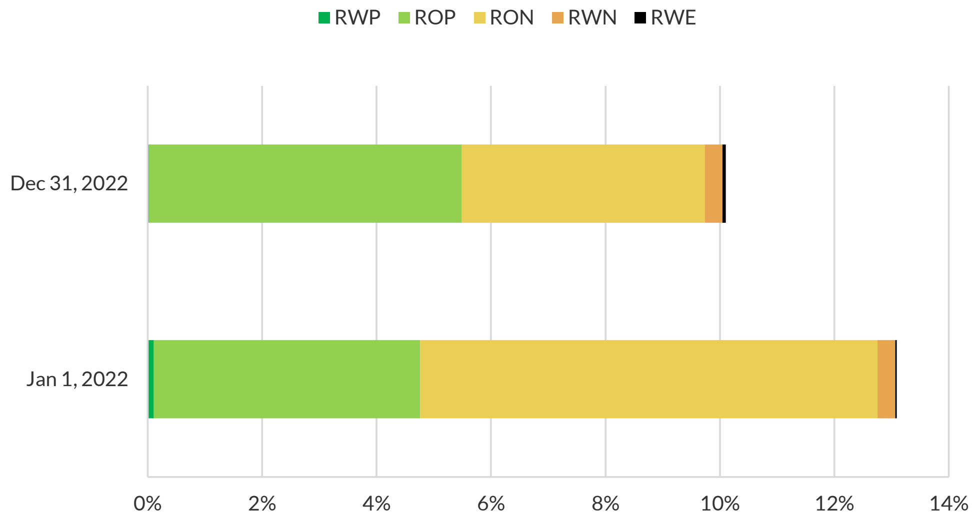
Sovereigns



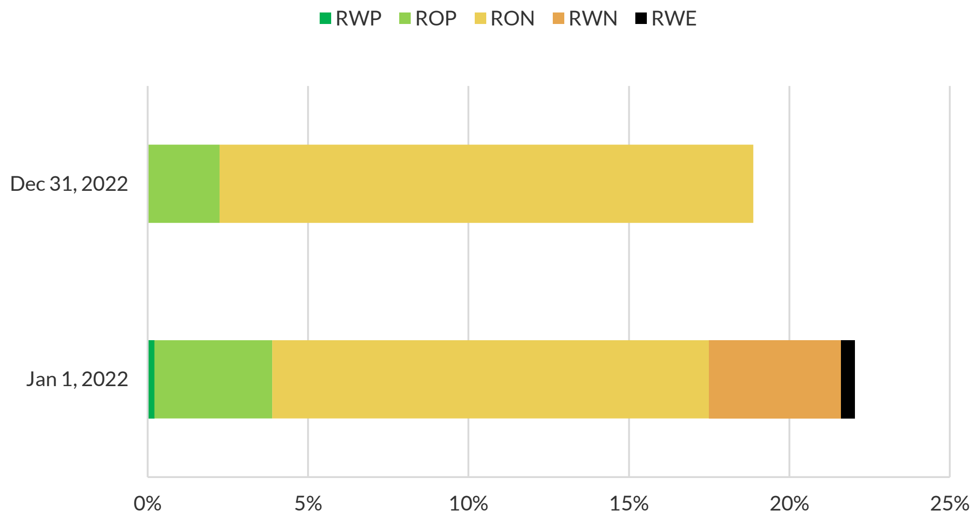
Structured Finance



U.S. Public Finance & Global Infrastructure



International Public Finance



Source: Fitch Ratings

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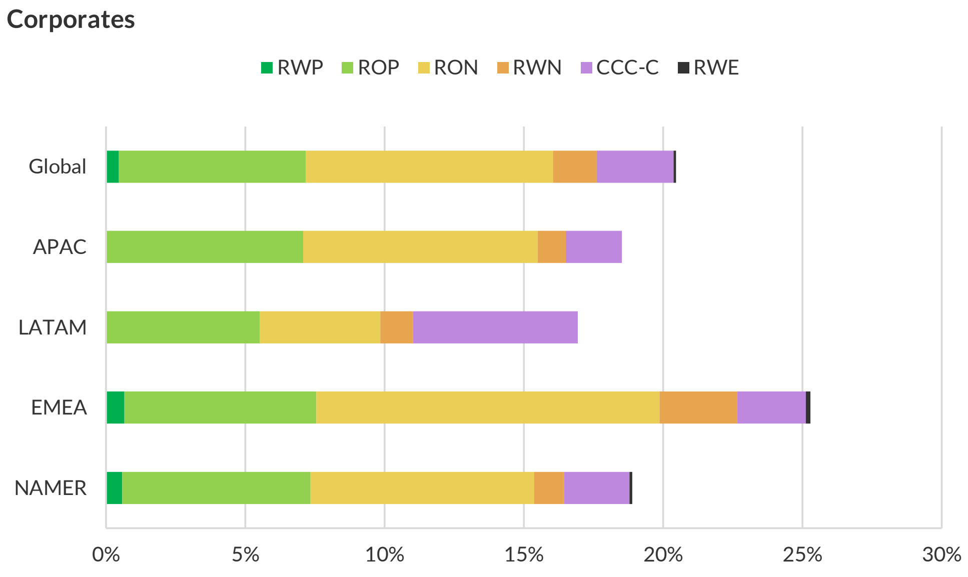
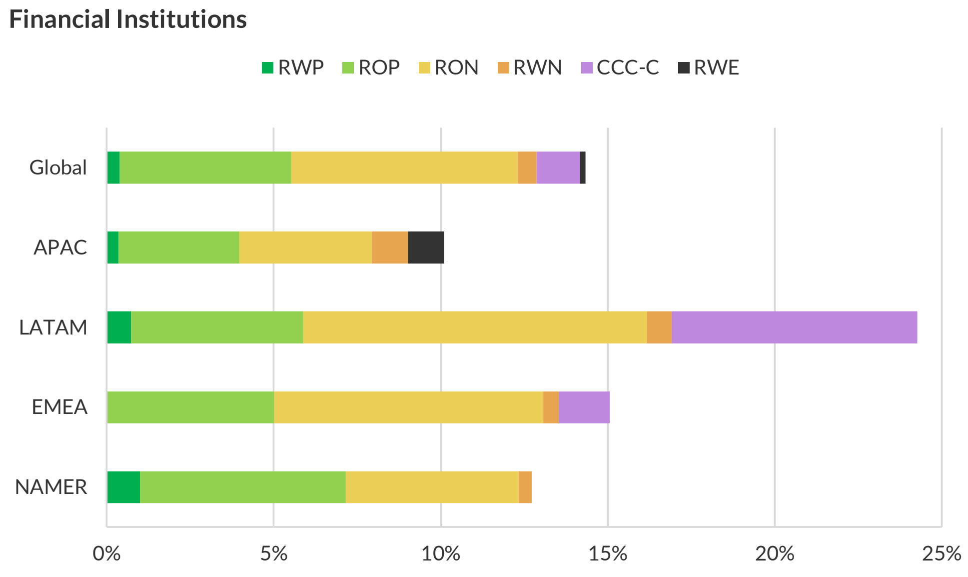
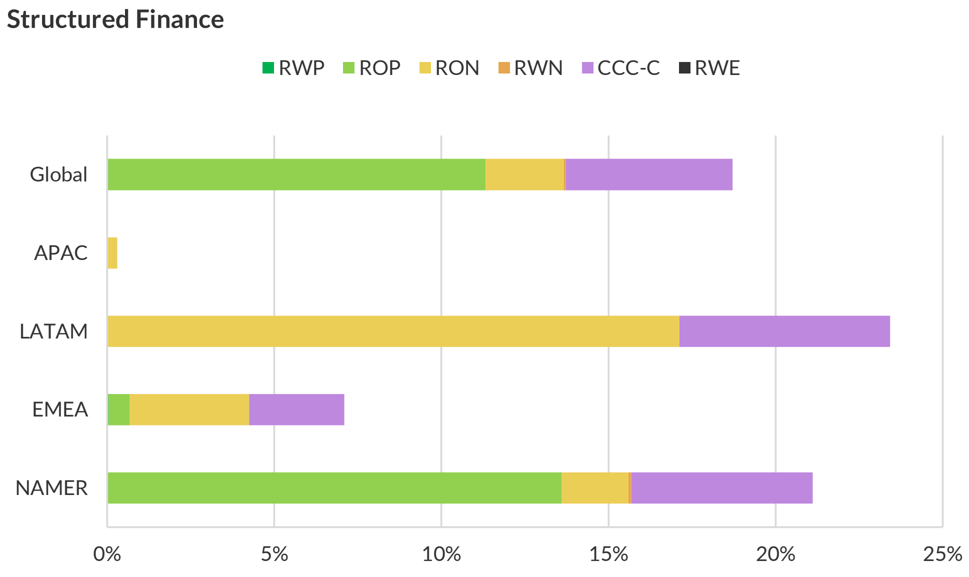
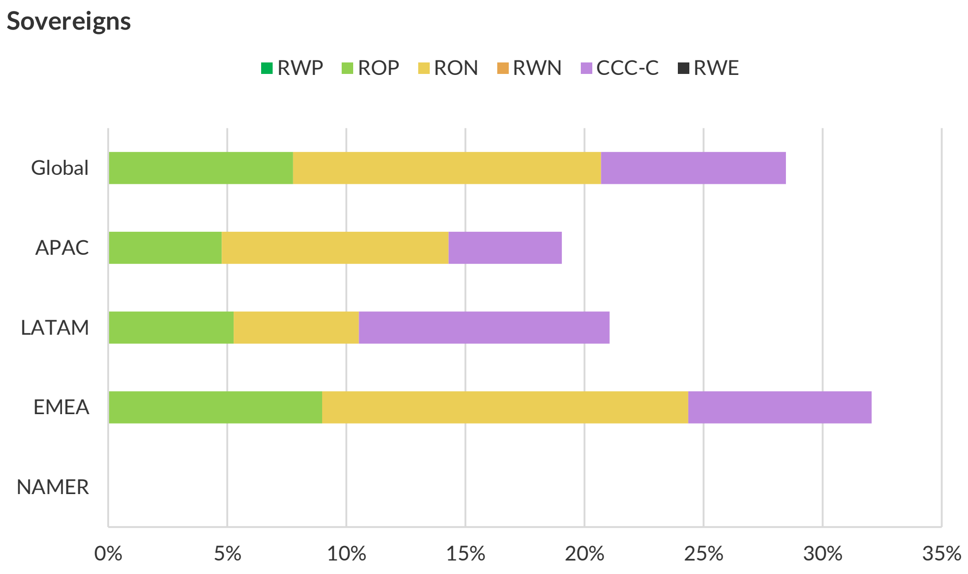
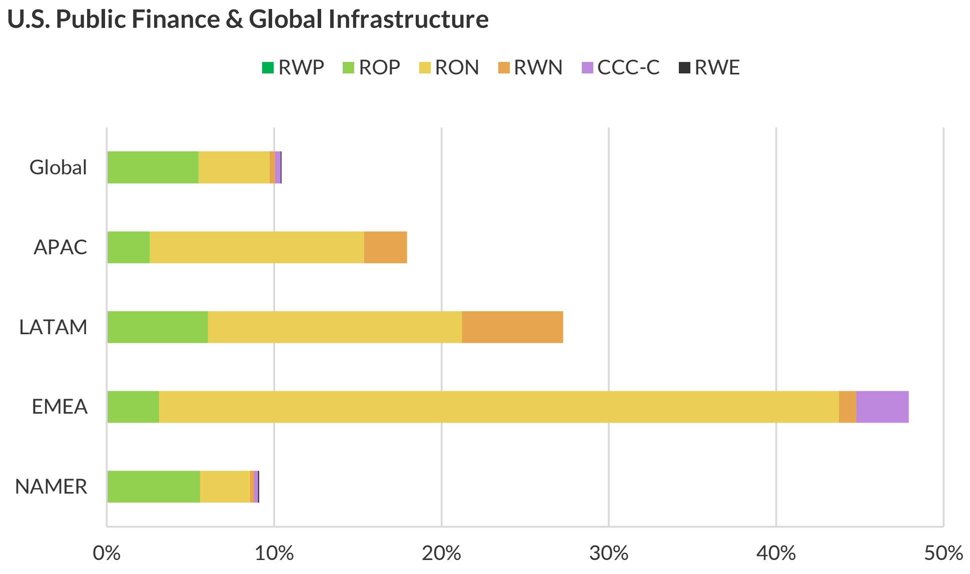
RATINGS SNAPSHOT: OUTLOOK & WATCH DISTRIBUTION BY GROUP (REGIONAL)

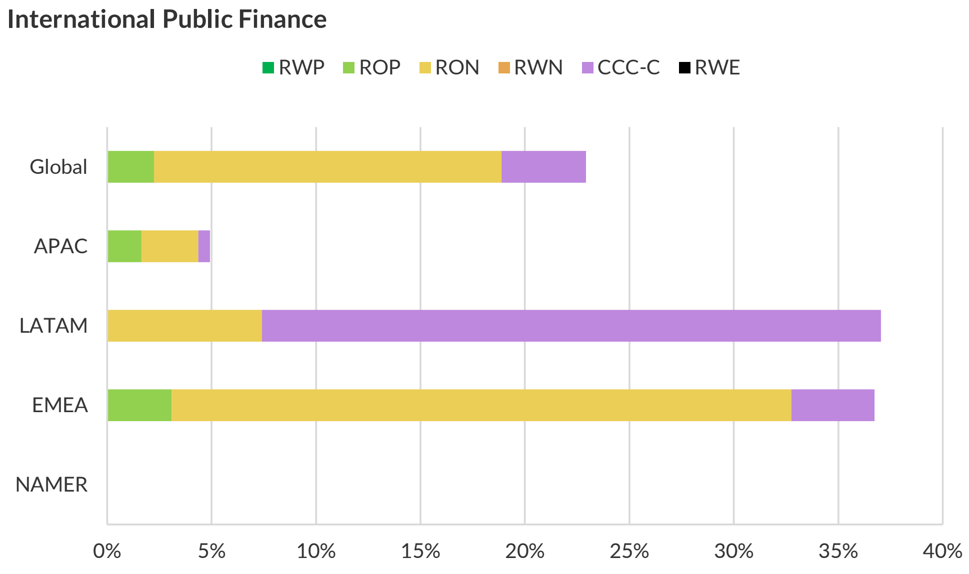












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FITCH RATINGS GLOBAL ECONOMIC OUTLOOK FORECASTS

GDP Growth (%)	2017-2021 (Average)	2021	2022F	2023F
U.S.	2.1	5.9	2.1	0.2
Eurozone	1.0	5.3	3.5	0.2
China	6.0	8.1	3.0	5.0
Japan	-0.2	1.7	1.4	1.1
UK	0.4	7.6	4.4	-1.2
EM ex. China	2.4	6.0	3.5	2.0
World	2.4	6.0	2.6	1.4

Interest Rates (% eop)	2017-2021 (Average)	2021	2022F	2023F
U.S.	1.25	0.25	4.50	5.00
Eurozone	0.00	0.00	2.50	4.00
China	3.15	2.95	2.75	2.75
Japan	-0.10	-0.10	-0.10	-0.10
UK	0.39	0.25	3.50	4.75

Unemployment (% eop)	2017-2021 (Average)	2021	2022F	2023F
U.S.	5.1	5.4	3.6	4.8
Eurozone	8.1	7.7	6.7	7.4
Japan	2.6	2.8	2.6	2.7
UK	4.3	4.5	3.7	5.0

Inflation (% eop)	2017-2021 (Average)	2021	2022F	2023F
U.S.	2.5	7.0	6.5	3.6
Eurozone	1.5	5.0	9.2	5.2
China	2.0	1.5	1.8	2.3
Japan	0.3	0.8	4.0	1.5
UK	2.1	5.4	10.5	4.5

Source: Fitch Ratings

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