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Policy Decisions Are Key To The 2013 Global Credit Outlook

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Policy Decisions Are Key To The 2013 Global Credit Outlook

In 2013 policymakers in the world's financial and political centers are likely to have an outsize influence on the capital markets. The actions taken--or not taken--in Frankfurt, London, Brussels, Washington, Beijing, and Tokyo are likely to be central to determining fiscal and monetary policy, economic growth, and credit conditions around the world. The markets themselves, of course, always speak loudly, while policymakers have always had influence. But the difference this time around, in our view, is that market participants are far more likely than at any time since the recession to take their cues from how regulators, politicians, and central bankers respond to the global slowdown.

Some of the overriding factors cited in our global credit outlook a year ago still weigh on the capital markets. The U.S. economic recovery remains muted, growth is slowing in Asia, and we see little if any growth at all in Europe, with its ongoing sovereign debt and banking crises. Yet the more the markets can see--and believe--that governments are attacking these problems, the surer and more widespread the global economic recovery is likely to be. Both domestic and international policy differences mean that this won't necessarily happen easily or quickly. But capital markets activity is more likely to improve with clear evidence that nations are strongly supporting their financial institutions and making credible, difficult domestic fiscal policy decisions--even as they and their central bankers work to stimulate their economies.

Overview

- Decisions by policymakers in the world's leading financial and political centers are likely to have a significant impact on the credit markets in 2013.
- Debt issuance is likely to remain strong for corporate issuers in 2013, especially for those with investment-grade ratings.
- The Fed and the European Central Bank are likely to keep interest rates low in 2013 to boost economic growth and support the credit markets.

Overall, Standard & Poor's Ratings Services' view is that 2013 will be a mildly negative year for the capital markets, though some parts of the credit markets, notably investment-grade companies, will continue to have the access they want at the low prices that they desire. And with interest rates at or near historic lows, investors will continue to seek out the higher returns of speculative-grade bonds. We expect that there will be moderate growth in these issues next year. It's most likely that we'll continue to see a negative trend in European bank ratings, especially in the southern tier of the eurozone, and among the largest U.S. banks, reflecting their ties to the U.S. sovereign rating, generally diminished profitability, or the outcome, for some, of regulatory changes. And we can expect to see a continued bifurcation among U.S. state government issuers, with those best able to adapt to economic conditions maintaining their ratings, while those that cannot seeing weaker credit quality and the potential for swift deterioration.

More Debt Issues Expected In 2013

Standard & Poor's expects that one way the world's central bankers will continue to influence capital markets in the coming year is by keeping the money supply plentiful, which will provide more opportunities for corporations to issue or refinance debt. With both the Federal Reserve and the European Central Bank (ECB) bent on keeping interest rates low, we saw significant increases in debt issuance in 2012, and barring a more severe downturn in Europe or recession in the U.S., we expect the trend to continue in 2013. Both investment-grade and speculative-grade issuance grew, providing investors with more options to pursue.

Speculative-grade instruments--and the higher yields they offer investors--have become increasingly attractive, thanks to the lower returns of most other financial assets. Speculative-grade bond issuance in the U.S. rose 25% in November 2012, compared to a year earlier. But the rapid growth of speculative-grade issuance may at some point be too fast for its own good. Some market participants already consider this market a bit "frothy," lacking only the many M&A deals that might make it comparable to 2006.

Globally, the issuance of all corporate debt rose 29% in the first 11 months in 2012, from the same period in 2011, to about $1.6 trillion, with the U.S. rated issues accounting for roughly one-third of that, or about $570 billion. But we've seen somewhat weaker credit quality recently, with credit downgrades outpacing upgrades by 2 to 1 in the second half of 2012, as issuers face prospects of limited revenue growth, less room for cost-cutting, weaker earnings in some sectors, and increasing leverage.

In their desire for higher yields, investors have also been returning to structured finance instruments. While this market as a whole is still below its pre-recession peak, largely reflecting the virtual collapse of private residential mortgage-backed security issuance, some structured securities are beginning to grow again in North America. Auto-loan asset-backed securities (ABS) have been, and we expect will continue to be, robust, while collaterized debt obligations and commercial mortgage-backed securities are also showing signs of improvement. Moreover, because the crises in Europe have diminished the credit markets there, we expect to see an increase in cross-border ABS financing in 2013, as deals originated there are sold in North America.

These trends should continue, barring some unexpectedly severe development that affects the global economy. One of those, of course, would be if the U.S. fails to avoid the fiscal cliff. We think it more likely than not that Democrats and Republicans in Washington will come to terms to avoid the ensuing severe spending cuts and higher tax rates that would harm the economy.

Policy Decisions Are Already Helping

In Europe, policymakers have coalesced around initiatives to support the credit markets and the banks there. One of the most significant of these is the Basel III capital accords, which strengthen the capital position of banks. We see this as an overall positive for credit quality in that it boosts market confidence in the stability of eurozone banks. Those standards are also set to take effect in the U.S.

Credit stability in Europe also benefited from the long-term refinancing operation (LTRO) launched in early 2012. Under this mechanism, the ECB bolstered eurozone banks with low-cost, long-term funding. Similarly, the ECB's decision to buy European sovereign debt on the open markets in 2012 helped restore confidence in some of the continent's shaky sovereign debt.

Three rounds of quantitative easing by the Fed have injected hundreds of billions of dollars into the money supply as it bought debt securities to promote economic growth. In its latest move, the Fed pledged in December to buy $45 billion of Treasury securities each month, in addition to its existing promise to buy $40 billion of mortgage-backed securities each month. The Fed for the first time also publicly linked its monetary policy to a specific unemployment goal, saying that it would maintain the low current federal funds rate of 0% to 0.25% at least as long as the jobless rate remains above 6.5%.

In the U.S. regulatory arena, some notable changes are still awaiting implementation, including the final interpretation of the Dodd-Frank Act's Volcker rule, which details the limits on banks' proprietary trading. Standard & Poor's has stated previously that depending on how this rule is interpreted, the largest U.S. banks could lose, in aggregate, as much as $10 billion annually in pretax earnings.

The most immediate policy concern in the U.S. is the fiscal cliff--the automatic increase in tax rates and federal spending cuts scheduled for Jan. 1, 2013. The longer it takes for Washington to reach an agreement after that date, the greater the chances the U.S. could fall back into a recession. That would have serious implications for U.S. state governments, many of which have already undergone several rounds of budget cuts and other fiscal adjustments. Although Medicaid spending, which is the greatest area of fiscal integration between the states and the federal government, has been exempted from sequestration, a recessionary economy would almost certainly increase participation in the program of medical care for the poor, creating additional budgetary pressure.

Beyond the fiscal cliff issue lies the possibility of realizing the so-called grand bargain, which would be a long-term plan to rationalize entitlements (especially Medicare), overall federal spending, and tax rates in a way that would gradually reduce the federal budget deficit. There is no assurance such an agreement can be reached in 2013, especially since the division of power in Congress has stayed the same. (We considered the U.S. election a neutral for the sovereign rating.) But a credible path toward a grand bargain, even if it were not immediately finalized, would go a long way, in our view, toward reassuring markets and revving up the U.S. economy.

The Slow Global Economy

Economically, some regions of the world will probably outperform others--even if not by very much. Growth in Europe will be flat, following a year in which GDP turned negative, while U.S. GDP will likely expand only a scant 2.3%. We estimate China's growth at about 8% next year, which while high compared to the West, is a significant drop from China's recent past. In our view, the Chinese authorities appear to have a handle on ensuring that their economy won't deflate too quickly and we look for a measured slowdown in 2013 rather than a crash landing. That, in turn, reduces significant risks for its big trading partners, such as Australia.

The other big Asian market, Japan, will be looking for ways to stimulate its deflationary economy in the wake of the election of Shinzo Abe as premier in December. All eyes will also be on the Bank of Japan, where in April 2013, the five-year term of its governor ends, and the bank could turn more aggressive about stimulating the economy. But in light of the sluggish growth in Japan, we retain our negative outlook on the Japanese sovereign rating.

The world's biggest economies are, then, facing some serious decisions that will go a long way toward putting the capital markets on a stronger footing. Central bankers have already gone far in alleviating some of the stress in the world's financial systems, and have done so in a generally transparent manner. There may only be so much more that they can do to reassure the market. Policymakers in the U.S., Europe, China, and Japan, on the other hand--and especially in the U.S.--have generated a cloud of uncertainty about the actions they'll take on fiscal policy. When it comes to reassuring the markets and strengthening the economy, they have their work cut out for them.

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