MOODY'S
INVESTORS SERVICE

INDUSTRY OUTLOOK

2014 Outlook – Global Credit Conditions

Stabilizing Economic and Financial Conditions Support Credit Quality of Global Debt

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Executive Summary

The gradual stabilization of the global economy will benefit many credit sectors as real GDP growth recovers in most advanced economies, while decreasing slightly in many emerging economies.[1]

US growth will drive strong credit performance in key sectors. US GDP growth will reach 2%-3% in 2014 and accelerate in 2015. The beneficiaries of the growth include US consumer products, lodging and retail; European building materials; US banks; US state and local governments and US transportation infrastructure agencies; US commercial mortgage-backed securities (CMBS), residential mortgage-backed securities (RMBS) and asset-backed securities (ABS) sectors such as auto ABS, credit card ABS and student loan ABS in the US structured finance sector; and the US sovereign.

Several large European economies are recovering or stabilizing, benefiting creditors. Several large euro area economies, such as France and Germany, which belong to the so-called euro area "core," are likely to have positive growth in 2014, providing a degree of stability to issuers and financial institutions in the region. Consumer-related industries in Europe's corporate sector will benefit from these early signs of stabilization, after a long period of market, economic and sovereign stress. Structured finance securities such as European RMBS and ABS will benefit from improving macroeconomic conditions in some countries. However, the deterioration in the asset quality of financial institutions in many European Union (EU) countries has yet to abate. In contrast to the euro area core, in Japan, the speed of the recovery remains doubtful, given uncertainty about the long-term implications for growth from "Abenomics," a new stimulus policy.

The moderation in China's growth rate has ramifications for global credit quality. China's growth in 2014 will remain close to 2013 levels and stabilize at 7.0%-8.0%. However, although not our central scenario, a further slowdown and rebalancing in China could create the potential for shocks in emerging as well as advanced countries. Commodities prices will continue to soften as the pace of emerging market growth slackens, especially the price of metals.

The effects of the US Federal Reserve's wind-down of quantitative easing (QE) program will be finite. The wind-down of the US Fed's quantitative easing program (QE tapering) will lead to higher funding costs in the global markets. Emerging markets will be particularly vulnerable to the negative effects of the QE tapering, but for both developed and developing economies, the impact will be only low and temporary.

[1] See 2014 Outlook - Global Sovereigns: Credit Quality Stabilizing After Several Tumultuous Years, 25 November 2014.

Credit effects of possible interest rate increases are largely negative. Rising rates will lead to tighter funding conditions, particularly in emerging economies. In Latin America, however, the primary sovereigns have solid buffers to protect against tighter funding conditions. Separately, QE tapering will have mostly credit negative effects for the US structured finance sectors, but will offer some benefit for US banks.

Improving Global Economic Conditions Support Stabilizing Credit Quality in Most Sectors

The gradual recovery of global economic conditions will benefit many credit sectors. Despite considerable risks, the global economy is now past the worst of the fallout from the financial crisis and subsequent recession. The transition is still likely to be slow and bumpy, but the economic outlook now seems more predictable. The global economy appears to be navigating towards calmer waters.[2]

As Exhibit 1 shows, real GDP growth rates in the advanced G-20 economies are moderate, around 1.3% in 2013, and will rise to 2.0% in 2014 and about 2.25% in 2015. Real GDP growth in the emerging G-20 economics has been higher, just below 5%, and will rise to 5.5% in the next two years.

EXHIBIT 1

Moody's Central Forecast for 2013-15

Countries [1]	2013F		2014F		2015F		Forecast uncertainty measures		
	Growth central range	Unemp't central range	Growth central range	Unemp't central range	Growth central range	Unemp't central range	2013 growth range [2]	2014 growth range [2]	GDP volatility [3]
Argentina [4]	2.5/3.5	--	2.5/3.5	--	2.5/3.5	--	2.6	5.5	6.3
Australia	2.0/3.0	5.0/6.0	2.0/3.0	5.0/6.0	2.5/3.5	4.5/5.5	0.6	1.1	1.0
Brazil	1.5/2.5	--	2.0/3.0	--	3.0/4.0	--	0.7	2.4	2.4
Canada	1.0/2.0	6.5/7.5	2.0/3.0	6.5/7.5	2.0/3.0	6.5/7.5	0.4	0.5	1.9
China	7.0/8.0	--	7.0/8.0	--	7.0/8.0	--	0.4	1.0	1.9
Euro area	-1.0/0.0	--	0.5/1.5	--	1.0/2.0	--	0.5	0.4	2.0
France	-0.5/0.5	10.5/11.5	0.5/1.5	10.5/11.5	1.0/2.0	10.0/11.0	0.6	0.5	1.7
Germany	0.0/1.0	5.0/6.0	1.0/2.0	5.0/6.0	1.0/2.0	5.0/6.0	0.3	0.6	2.3
India	4.0/5.0	--	4.5/5.5	--	5.5/6.5	--	2.9	1.5	2.4
Indonesia	5.0/6.0	--	5.0/6.0	--	5.5/6.5	--	1.4	1.6	4.9
Italy	-2.0/-1.0	11.5/12.5	0.0/1.0	12.0/13.0	0.0/1.0	11.5/12.5	0.5	0.9	2.2
Japan	1.5/2.5	3.5/4.5	1.0/2.0	3.5/4.5	1.0/2.0	3.5/4.5	0.6	0.9	2.4
Mexico	1.0/2.0	--	2.5/3.5	--	3.0/4.0	--	2.4	1.1	2.6
Russia	1.0/2.0	--	2.5/3.5	--	2.5/3.5	--	0.8	1.3	4.9
Saudi Arabia	3.5/4.5	--	3.5/4.5	--	3.5/4.5	--	0.9	0.4	3.1
South Africa	1.5/2.5	--	2.5/3.5	--	2.5/3.5	--	0.5	0.5	1.9
South Korea	2.0/3.0	--	3.0/4.0	--	3.0/4.0	--	0.6	0.6	3.8
Turkey	3.0/4.0	--	3.5/4.5	--	3.5/4.5	--	0.9	1.6	5.1
UK	1.0/2.0	7.5/8.5	1.5/2.5	7.0/8.0	2.0/3.0	7.0/8.0	0.9	1.5	2.4
US	1.0/2.0	7.0/8.0	2.0/3.0	6.5/7.5	2.5/3.5	6.5/7.5	0.4	0.8	2.0
G-20 All	**2.0/3.0**	--	**2.5/3.5**	--	**3.0/4.0**	--	--	--	--
G-20 Advanced	**1.0/2.0**	--	**1.5/2.5**	--	**2.0/3.0**	--	--	--	--
G-20 Emerging	**4.5/5.5**	--	**4.5/5.5**	--	**5.0/6.0**	--	--	--	--

Notes: Green shading denotes improvement from the August 2013 update, orange denotes deterioration. Blue shading denotes considerable forecast uncertainty relative to historical GDP volatility. [1] G-20 All includes the 19 individual countries that comprise the G-20, weighted by nominal USD GDP shares. G-20 Advanced includes Australia, Canada, France, Germany, Italy, Japan, South Korea, the UK and the US. [2] The percentage point difference between the highest and lowest forecasts of sources such as the International Monetary Fund (IMF), World Bank (WB), Organization for Economic Co-operation and Development (OECD), European Commission, JPMorgan, Barclays, and Moody's Analytics. [3] The standard deviation of real GDP growth over the 15 years to 2012. [4] In February 2012, the IMF approved a decision that calls on Argentina to implement specific measures to address the quality of reported GDP and Consumer Price Index data; on 1 February 2013, the IMF's Executive Board found that progress had not been sufficient and issued a declaration of censure against Argentina under its Articles of Agreement.
Source: Moody's Investors Service

[2] See Global Macro Outlook 2013-15: Navigating Towards Calmer Waters, 12 November 2013.

US growth will benefit many credit sectors

A key factor underpinning the renewed growth prospects for advanced countries is the firming of the economic recovery in the US (Aaa stable), which started in 2010. US GDP growth will reach 2%-3% in 2014 and continue accelerating in 2015. US budget deficits have declined and will continue to do so over the next few years as growth strengthens.

US growth will benefit many corporate sectors in the US, including consumer products, lodging and retail. The recovering US housing market[3] will also benefit corporate sectors abroad such as European building materials companies, which rely on the US residential construction market for growth in cement demand.

US financial institutions are also benefiting from the more stable economic environment. According to our economic projections, the improvement in US banks' asset quality metrics that began in first-quarter 2010 will continue. Loan losses at the US banks will remain at or below pre-crisis levels. As a result, banks will continue to build up their capital through earnings, which will result in higher capital ratios and bolster their creditworthiness. Improvement in the housing market will accelerate the improvement in US banks' asset quality metrics by reducing the balance of banks' non-performing assets and lessening the need for incremental provisions to cover the cost of loan repurchases related to claims of breaches of representations and warranties on residential mortgages.

Higher growth will support US sovereign creditworthiness, as well as improve state and local government credit conditions. Federal government budget deficits have been declining and will continue to do so over the next few years as growth strengthens. Our expectations for the US government's declining debt-to-GDP ratio through 2018 underpinned our decision in mid-2013 to change the outlook for the US rating back to stable from negative.[4] The credit quality of the US state and local government sectors is stable in light of modest but steady increases in economic output and employment, as well as the improvement in the housing market. As a result, in 2013, we also changed our outlook for these sectors to stable from negative.

For US transportation infrastructure enterprises and public power agencies, credit conditions will also improve, because customer demand and revenue will likely track the improvement in the US economy. Public-private partnerships will increasingly fund and develop US infrastructure projects as state and local governments continue to seek ways to manage capital costs amid the modest economic recovery.

Growth in the US, however, will not be strong enough to halt the decline in the credit quality of US higher education and not-for-profit healthcare entities; we are thus maintaining our negative outlook for these sectors. For universities, costs continue to rise, and the federal funding outlook remains poor. Hospitals will have to address challenges stemming from slowing revenue growth, declining patient volumes and federal reimbursement cuts amidst the implementation of federal health care reform.

In the US structured finance sector, many outstanding securitizations will benefit from economic growth. Lower vacancies and higher rents for commercial spaces will improve the credit performance of several CMBS sectors. For US RMBS, the number of delinquent mortgages and mortgage loans in foreclosure will decline as the economy and employment improve. The performance of auto, credit card and student loan ABS collateral will remain strong or improve. For US CLOs, the default rate of the underlying debt will remain low as the economy continues to expand.

[3] See Cross-Sector Impact of US Housing Recovery Will Be Predominantly Credit Positive, 24 July 2013.

[4] See Moody's changes outlook on US Aaa sovereign rating to stable from negative; rating affirmed, 18 July 2013.

Early signs of stabilization in Europe mark a significant shift

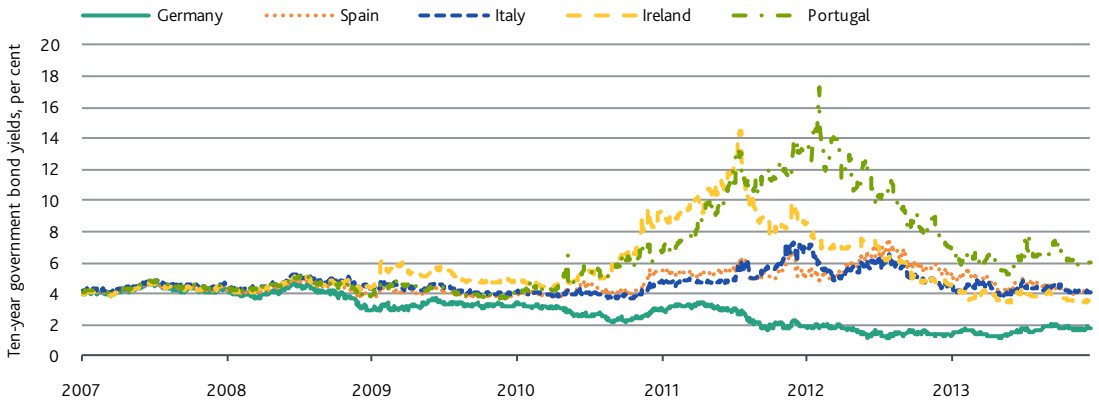
In a significant shift, after several years of intense market, sovereign and economic stress, several large euro area economies are finally emerging from recession, providing issuers and banks in the region some stability. Euro area real GDP growth will be 0.0%-1.0% in 2013, improving to a still modest pace of 0.5%-1.5% in 2014. Nonetheless, macroeconomic conditions for issuers in Greece (Caa3 stable), Italy (Baa2 negative), Spain (Baa3 stable) and Portugal (Ba3 stable) will remain difficult.

Signs of stabilization in investors' perceptions of risk are also apparent in sovereign bond yields, which have declined from very elevated crisis levels for the peripheral euro area countries, as Exhibit 2 shows. The remaining disparities among euro area sovereign bond yields translate into higher borrowing costs for entities in countries like Italy and Spain than in Germany (Aaa negative), for example. Higher borrowing costs will adversely affect credit demand and the broader economy, while supporting interest margins for banks in the peripheral countries.

EXHIBIT 2

Euro Area Sovereign Bond Yields

January 2007-November 2013



Source: Moody's Investors Service, based on data from Haver Analytics

For European corporates, consumer-related industries will benefit from improving economic conditions. We expect European retailers to report modest sales gains in 2014 following several years of declines. We are forecasting that European auto sales, having bottomed out in 2013, will rise 3% in 2014.

The deterioration in asset quality in the financial institutions of many EU countries has yet to abate. In a number of countries, the number of problem loans will continue to rise because of persistent economic stress. Key downside risks include negative surprises because of un- or under-reported asset quality deterioration and capital shortfalls that are higher than our expectations. The forthcoming comprehensive assessment by the European Central Bank will facilitate the comparability and improve the transparency of banks' balance sheets, and the assessment will prompt EU banks to further bolster their capital buffers.

Growth in core EU traffic underpins our stable outlook for the European transportation infrastructure industry. We are forecasting core EU toll-road growth of up to 3% in 2014; however, traffic growth for the peripheral EU toll roads and airports will be flat. Core EU airports will outperform toll roads. High exposure to the United Kingdom (Aa1 stable) is the main reason for our stable outlook for private finance initiatives and public-private partnerships in Europe and the Middle East.

Neutral or positive growth in Europe will stabilize asset prices and benefit European structured finance securitizations. However, credit performance in RMBS, ABS and small and medium-sized enterprises (SMEs) will vary by country because unemployment will remain high and growth will be low in some countries. For example, in the UK, the domestic economic recovery and low interest rates will help

RMBS. In contrast, in Spain, with its low GDP growth and high unemployment, the credit quality of securitizations will deteriorate, although at a slower pace than in previous years.

Other securitizations will stabilize or remain stable. Increased commercial real estate investment and more liquidity in the EU property markets will help stabilize weak CMBS legacy deals in Europe. Default rates for European CLO assets will remain low, given manageable refinancing risk, and most transactions will continue to amortize.

For the government sectors, as growth resumes in the European economies, improved revenue generation and lower social welfare-related expenditures will support fiscal consolidation efforts to contain government debt accumulation. Fiscal deficits have fallen but remain historically high in several countries; elevated debt levels continue to constrain sovereign creditworthiness. The debt of the major European economies will plateau in 2014 and then decline gradually over the years following.

Meanwhile, signs of economic stabilization, institutional improvements and the development of firewalls and backstop facilities, such as the European Stability Mechanism and availability of ECB liquidity measures, have led to a reduction of euro-area-wide contagion risks. Consistent with this development, between September and December 2013, we changed to stable from negative our outlooks for some of the region's sovereign credits: Ireland (Ba1 stable), Malta (A3 stable), Portugal (Ba3 stable), Slovakia (A2 stable), Spain (Baa3 stable) and Greece (Caa3 stable).[5]

Signs of stabilization in economic and financial conditions in the euro area have also had positive implications for other regional trading partners. This effect has been especially true for countries in regions more closely linked to the euro area via real and financial channels, i.e., the EU countries outside the monetary union, as well as those in Central and Eastern Europe (CEE), and countries in the Commonwealth of Independent States (CIS) and in the Middle East and North Africa.

Fiscal stimulus in Japan provides a temporary boost

Aggressive monetary easing and fiscal stimulus have temporarily boosted the economy in Japan (Aa3 stable). If these policies were to succeed in spurring long-lasting growth and ending deflation, the outcome would be credit positive for Japan's heavily indebted national, regional and local governments. Japanese banks and insurers would also benefit from stronger growth and normalization of interest rates. Higher property prices and increased bank lending would benefit commercial real estate structured finance sectors, while employment growth would benefit RMBS and ABS.[6]

However, achieving long-lasting growth hinges on the success of structural reforms to boost the economy's growth rate. If growth remains elusive, the government's stimulatory policies risk aggravating the credit challenges for Japan's corporates, financial institutions and various levels of government, which are already suffering because of the low growth and low return environment.

Effects of a slowdown in China's growth would be far-reaching if it resulted in lower demand

In line with policymakers' efforts, growth in the economy of China (Aa3 stable) appears to be slowing from the fast pace of recent years, avoiding a hard landing. China's growth in 2014 will remain close to 2013 levels, stabilizing at 7.0%-8.0%.

[5] See Moody's changes outlook on Ireland's Ba1 rating to stable from negative, 20 September 2013; Moody's changes outlook on Malta's A3 rating to stable from negative, 4 October 2013; Moody's changes outlook on Portugal's Ba3 rating to stable from negative, 8 November 2013; Moody's changes outlook on Slovakia's A2 rating to stable from negative, 4 October 2013; Moody's changes outlook on Spain's Baa3 government bond rating to stable from negative, 4 December 2013; and Moody's upgrades Greece's government bond rating to Caa3 from C; stable outlook, 29 November 2013.

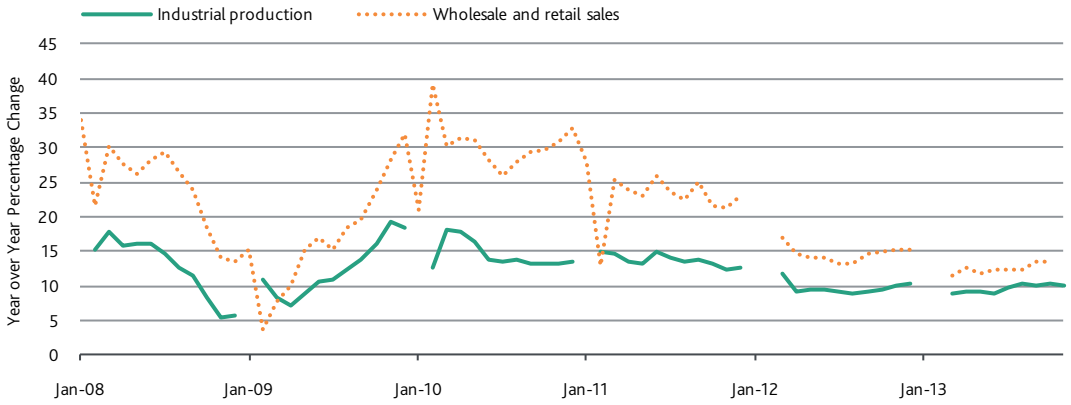
[6] See Abenomics Success Prospects Constrained By Fundamental Macroeconomic Challenges, Risks Aggravating Credit Challenges If Growth Remains Elusive, 27 August 2013.

Short-term indicators such as industrial production and retail sales are consistent with the slowing pace of China's economic expansion. Exhibit 3 shows the recent deceleration of growth in China's industrial production and retail sales.

EXHIBIT 3

Short-Term Indicators of Chinese Economic Activity

January 2008-September 2013



Source: Moody's Investors Service, based on data from Haver Analytics

Risks are growing because of the fast pace of property price increases as well as financial stability issues associated with the shadow banking sector, but these risks do not currently appear to be crystallizing.

However, a decline in demand from China would have far-reaching effects. For example, a decline in Chinese demand for commodities would dampen revenue growth and weaken the government finances of commodity-exporting countries, particularly Australia (Aaa stable) and Indonesia (Baa3 stable).

Effects of Wind-Down of Quantitative Easing Will Be Finite

The wind-down of US Federal Reserve's QE program in 2014 will lead to higher funding costs in the global financial markets. Emerging economies and market segments that investors perceive to be more vulnerable to rising rates will likely come up against further funding outflows and a decline in the availability of credit. Countries with external imbalances, especially emerging markets, are the most at risk, as the significant financial volatility in mid-2013 revealed.

However, the move toward normalization of monetary policy in the US will have only a relatively small and temporary impact on most of the developing economies.[7]

In Latin America, five sovereigns – Brazil (Baa2 stable), Chile (Aa3 stable), Colombia (Baa3 positive), Mexico (Baa1 stable) and Peru (Baa2 positive) – have solid buffers, for example, large hard currency or fiscal reserves, against the further tightening of funding conditions that could result from QE tapering. Mexico has the largest risk for reduced capital flows owing to large inflows during the QE period. Nevertheless, funding costs for the five sovereigns will rise 100-150 basis points over the next 12-18 months.[8]

In the CEE5 – the Czech Republic (A1 stable), Poland (A2 stable), Slovakia (A2 stable), Romania (Baa3 negative) and Hungary (Ba1 negative) – the vulnerability of sovereign funding following QE will reflect the size and liquidity of the domestic funding pool. Based on their domestic funding pools and

[7] See US Fed Tapering: Effects Likely to be Relatively Limited and Temporary, 30 September 2013.

[8] See Latin America: Strengthened Sovereigns, Banking Systems Will Help Region Navigate a Post-QE World, 23 September 2013.

gross financing requirements, the Czech Republic and Slovakia are the least vulnerable to tightening liquidity conditions, followed by Poland, Romania and then Hungary.[9]

For Turkey (Baa3 stable), the likely impact of QE tapering on the sovereign, the country's banking system and corporate sector will also be temporary and will not cause any extensive damage, like a "sudden stop" of funding flows, given the range of buffers, e.g., hard currency reserves, that have built up in various parts of Turkey's economy since the 2009 recession. Turkish covered bonds benefit from even greater resistance to shifts in funding costs.[10]

Credit Effects of Possible Interest Rate Increases are Largely Negative

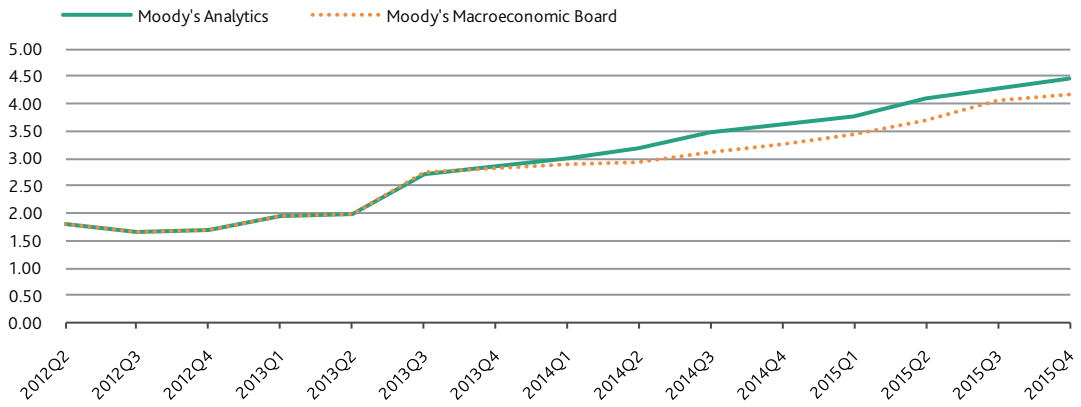
The tapering of the US Fed's QE program will increase the likelihood that interest rates will continue to rise globally, a generally credit negative development.

Benchmark US Treasury bond yields and long-term borrowing costs will likely rise in response to QE tapering next year. Exhibit 4 charts our forecast for ten-year US bond yields through 2015F.

EXHIBIT 4

Ten-Year Bond Yields Will Likely Rise as Federal Reserve Winds Down QE Program

Projections for ten-year bond yields, second-quarter 2012 to fourth-quarter 2015F



Source: Moody's Investors Service

Many emerging market banking systems will encounter even greater funding outflows when global interest rates rise and investors re-assess the risk-return trade-off, particularly if elevated asset prices in these countries start to decline.

For US banks, a rise in short- and long-term interest rates will benefit the banks' net-interest margins (i.e., the spread earned on money lent vs. money borrowed). A rise in only long-term rates would mean a far slower improvement in the banks' net interest margins; a rise in long-term rates would also dampen mortgage-origination revenue.

QE tapering will have mostly negative effects on the US structured finance sectors: Benchmark Treasury bond yields and long-term borrowing costs will rise, tempering the performance of securitizations. For US CMBS, the credit quality of most new deals will slip as US long-term bond yields rise and issuers loosen underwriting criteria. For US RMBS, refinancing will decline, lenders will have a harder time finding borrowers, underwriting standards will loosen and the credit quality of new loans will decline. For existing US CLOs, loan prepayments will slow and refinancing will become more challenging. For US ABS, a rise in short-term rates will be negative for auto ABS and credit card ABS because of the importance of short-term rates in these sectors.

[9] See CEE5: Size and Liquidity of Domestic Funding Pool Determine Vulnerability to Liquidity Constraints in Post-QE World, 9 October 2013.

[10] See QE Tapering & Turkey: Impact on Various Sectors of Turkish Economy Will Likely be Limited and Short-Lived Given Existing Buffers, 2 December 2013.

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- Moody's changes outlook on Malta's A3 rating to stable from negative, October 2013
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